Canadian Investment Funds Course

Printed Text

IFSE Institute

Tel: 1-888-865-2437
Fax: 905-803-0944

www.ifse.ca

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How to Study for the Canadian Investment Funds Course

The Canadian Investment Funds Course (CIFC) Printed Text is intended to act as a supplement to the online course. It is to be used in conjunction with the online course.

How Much Time Should You Spend Preparing?

We recommend that you spend at least 90 hours preparing to write the exam.

Suggested Approach for Each Unit

For each unit, you should:

1. Read the unit carefully.
   Make sure that you understand the terms and concepts.

2. Try the Online Exercises.
   To reinforce the concepts, try the suggested online exercises located within each unit.

3. Complete the Quizzes found online.
   The quizzes can be found at the end of each online unit.

4. Complete the Sample Exam found online.
   The sample exam can be found online on the course landing page.

Things to know for the Final Exam:

- The final exam is a formal proctored exam consisting of 100 multiple choice questions.
- The exam is worth 100% of your grade.
- You will have 3 hours to complete it.
- You will be required to obtain a mark of 60% to pass.

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Launching the Online CIFC Course

1. Go to the website www.ifse.ca

2. In the Login box in the top right-hand corner, enter your User Name and Password, then select LOGIN.

3. Under My IFSE > Courses > Canadian Investment Funds Course, select Launch this course.

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Unit 1: Regulatory Environment

Introduction

In Canada, there are a number of regulatory bodies and regulations that govern the sale of investment funds. As a Dealing Representative, you need to be aware of these bodies and regulations. Once you are licensed, your mutual fund dealer will provide further training about your responsibilities.

This unit takes approximately 1 hour to complete.

Lessons in this unit:

- Lesson 1: Regulatory Bodies and Securities Legislation
- Lesson 2: Other Legislation and Regulations

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Lesson 1: Regulatory Bodies and Securities Legislation

Introduction

The sale of investment funds in Canada is regulated and monitored by a number of provincial and federal authorities. As a Dealing Representative, you need to be aware of the authorities and regulations that affect you in the province/territory where you sell investment funds. This lesson provides an introduction to the regulatory bodies. Your Compliance Department can provide more detailed training on your responsibilities.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- discuss the financial services regulatory bodies
- explain how securities regulation is structured in Canada
- explain the role of each regulatory body:
    - Provincial securities regulators
    - Canadian Securities Administrators (CSA)
    - Self-Regulatory Organizations (SROs)
    - Canadian Investment Regulatory Organization (CIRO)
    - Ombudsman for Banking Services and Investments (OBSI)
    - Office of the Superintendent of Financial Institutions Canada (OSFI)
- list the legislation that regulates the securities industry

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Financial Services Regulatory Bodies

When you become a Dealing Representative, you will be part of a group of professionals that must adhere to regulations designed to protect the interests of both the investing public and industry participants.

In Canada, there are several monitoring bodies in the investment funds industry at the provincial and national level.

Provincial and Territorial Level	National Level
Each province and territory has a regulatory body, often referred to as a securities commission.	The following organizations all play a role in the regulation of the investment funds industry: • Canadian Securities Administrators (CSA) • Canadian Investment Regulatory Organization (CIRO)[1] • Ombudsman for Banking Services and Investments (OBSI) • Office of the Superintendent of Financial Institutions Canada (OSFI)

Securities Regulators Mandate

All provinces and territories have a regulatory body (securities regulator), often referred to as a securities commission, which administers that jurisdiction's Securities Act or equivalent legislation.

Each securities regulator sets its own standards for registration and has the power to grant or revoke registration. Securities regulators generally have a mandate to:

- protect investors from unfair, improper, and fraudulent practices
- promote fair and efficient capital markets
- promote confidence in the capital markets
- reduce systemic risk

[1] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

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For registered firms and individuals that are directly regulated by the provincial and territorial securities regulators, the rules, regulations, and legislation apply specifically to securities, and are not extended to related investment products. This differs from the regulatory requirements for registered firms who are regulated by the Canadian Investment Regulatory Organization (CIRO). CIRO member firms and their Dealing Representatives are subject to rules and regulations that apply to securities and related investment products, including structured products. For the purposes of this course, the terms “securities” and “investment products” are used interchangeably, though both apply to mutual fund dealers and their Dealing Representatives.

Securities Regulator/Securities Commission Role

Each securities regulator is responsible for the following:

- establishing the standards for disclosure of information before new securities can be offered to the public
- reviewing and approving mutual funds and new issue prospectuses before they are offered for sale in their province or territory
- registering the companies and individuals who sell securities in their province or territory
- registering the companies and individuals that manage investment fund portfolios in their province or territory
- enforcing securities regulations governing the buying and selling of securities
- investigating investor complaints against companies and their employees
- disciplining companies or individuals found to contravene the regulations

Your role as a Dealing Representative is to:

- register with your securities regulator
- adhere to the securities regulator's legislation, rules, regulations, and standards

Canadian Securities Administrators (CSA)

The Canadian Securities Administrators (CSA) is a policy-making body composed of members from each provincial/territorial securities regulator. It is a forum for Canada's securities regulators to improve, coordinate, and harmonize regulation of the Canadian capital markets.

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The CSA's stated mission is:

"To give Canada a securities regulatory system that protects investors from unfair, improper or fraudulent practices and fosters fair, efficient and vibrant capital markets, by developing a national system of harmonized securities regulation, policy and practice."

While the CSA develops policy and securities regulations, it is not charged with any responsibilities governing registration, compliance, or enforcement. Each of the provincial and territorial securities regulators has the authority to enforce the securities legislation and regulations in its jurisdiction.

Self-regulatory Organizations (SROs)

The provincial/territorial securities regulators have delegated their powers in certain specific areas to the self-regulatory organizations (SROs). An SRO is an organization that has been given the authority and the responsibility to regulate its members.

SROs in the securities industry include the:

- Canadian Investment Regulatory Organization (CIRO)
- Chambre de la sécurité financière (CSF)

The SROs are accountable to the provincial and territorial securities regulators. They must comply with the terms of their recognition order, their rules must be approved by the securities regulators, and they are subject to periodic inspection by the securities regulators.

The members of the SROs must:

- become registered with the securities regulators in the provinces and territories; and

- become members of the SRO.

For example, mutual fund dealers must be registered with the provincial and territorial securities regulators and they are also required to become members of CIRO.

The SROs have oversight over their member firms and their Dealing Representatives, Investment Representatives, Registered Representatives, and other Approved Persons. The SROs also have the authority to enforce their rules and conduct investigations of alleged misconduct.

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The Canadian Investment Regulatory Organization (CIRO)

The Canadian Investment Regulatory Organization (CIRO) is the SRO with oversight for investment dealers and mutual fund dealers in Canada.

CIRO's mission is to:

- protect investors
- provide efficient and consistent regulation
- build Canadians' trust in financial regulation and the people managing their investments

CIRO has oversight for its member firms and their Representatives, called "Approved Persons" in CIRO's rules and regulations.

The activities that CIRO carries out under its mandate are summarized below.

CIRO Mandate	
Mandate	**Description**
Registration	• screening applicants for registration • administering the registration of member firms and Approved Persons
Financial Compliance	• conducting audits of members' financial condition to ensure that they maintain adequate capital and insurance • if found deficient, invoking remedial action which could include the suspension of the firm's trading privileges
Business Conduct Compliance	• conducting audits of members to ensure that they have effective procedures in place to supervise the handling of client accounts including Know Your Client (KYC), Know Your Product (KYP), and suitability
Enforcement	• conducting investigations of complaints • conducting investigations of non-compliance with CIRO rules and securities regulations/legislation detected by means other than complaints (e.g. compliance audits) • prosecuting firms and individuals at hearings and imposing penalties including fines, suspension, and termination/prohibition
Regulatory Policy	• establishing new rules, policies, and regulations • updating and amending existing rules, policies, and regulations

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Ombudsman for Banking Services and Investments (OBSI)

The Ombudsman for Banking Services and Investments (OBSI) is the official dispute resolution body for the securities industry. While OBSI is recognized by the CSA, OBSI is not a regulator and its recommendations are not binding. All dealers must become members of OBSI except those dealers in Québec. In Québec, investors use a mediation process administered by the Autorité des marchés financiers (AMF).

If OBSI decides in favour of an investor, it has the authority to recommend that the firm compensate the investor up to a limit of $350,000. OBSI provides a mechanism for investors to pursue restitution from registered firms and their Dealing Representatives as an alternative to the legal system.

Office of the Superintendent of Financial Institutions (OSFI)

The Office of the Superintendent of Financial Institutions Canada (OSFI) supervises and regulates federally registered banks and insurers, trust and loan companies, and federally regulated private pension plans. OSFI does not regulate mutual fund dealers or other firms registered under securities legislation.

OSFI's mandate is to:

- protect the rights and interests of depositors, policyholders, financial institution creditors, and pension plan beneficiaries
- contribute to public confidence in the Canadian financial system

Securities Legislation and Regulation for Investment Funds

The investment fund industry is mainly regulated under the:

- Securities Acts
- National Instruments
- Mutual Fund Dealer Rules

Registered firms are responsible for interpreting securities legislation and regulations and establishing their firm's policies and procedures. Dealing Representatives are required to follow their firm's policies and procedures.

The regulation of securities in Canada starts with the Securities Act for each of the provinces and territories. A Securities Act decrees the law which governs securities. Investment funds are securities and are therefore governed under the Securities Acts, which are extensive pieces of legislation that cover the entire field of securities. The Securities Acts contain important provisions regarding investment funds.

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The responsibility for administering and enforcing the Securities Act in each jurisdiction rests with the provincial/territorial securities regulator.

National Instruments

National Instruments are harmonized national securities regulations made by the CSA. The main instruments affecting investment funds are below:

National Instruments	
NI 31-103	***NI 31-103 Registration Requirements and Exemptions*** provides the harmonized registration rules for the registration of firms and individuals with the provincial and territorial securities commissions.
NI 81-101	***NI 81-101 Mutual Fund Prospectus Disclosure*** establishes the requirements to ensure that mutual funds disclose the information that investors should consider when deciding whether to invest, or remain invested, in a fund. It prescribes the content of key disclosure documents including the simplified prospectus and the Fund Facts.
NI 81-102	***NI 81-102 Investment Funds*** is the main instrument regulating investment funds. It regulates how investment funds are managed, bought, and sold.
NI 81-105	***NI 81-105 Mutual Fund Sales Practices*** establishes the requirements to ensure that mutual funds are sold based on what is suitable for, and in the best interests of, investors. It sets minimum standards of conduct to be followed by managers, principal distributors, registered dealers, and Dealing Representatives when distributing mutual funds.

SRO Regulation

The SROs, including the Canadian Investment Regulatory Organization (CIRO) and the Chambre de la sécurité financière (CSF), have the authority to establish and enforce their Rules with the purpose of regulating their members in order to fulfill their regulatory mandate.

The SRO Rules are designed to:

- ensure that member firms of the SRO are financially strong
- provide specific rules of conduct for member firms and their Representatives

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In tandem with their Rules, the SROs establish Policies and Regulations which also govern the conduct of their member firms and their Representatives. The SROs also issue Bulletins and Notices which, amongst other things, are used to request public comments on proposed regulation, provide updates on policy development, or provide guidance and best practices for complying with securities legislation and regulations.

SRO Regulation (CIRO and CSF)
Rules
Policies and Regulations
Bulletins and Notices

Mutual Fund Dealer Rules

Mutual fund dealers are subject to the Mutual Fund Dealer Rules under CIRO. The Mutual Fund Dealer Rules set out detailed requirements for member firms including those for:

- business structures
- business conduct
- financial and operations requirements
- insurance
- books, records, and reporting
- examinations and investigations
- discipline
- new registrant training and supervision
- minimum standards for account supervision
- complaint handling, supervisory investigations, and internal discipline
- internal controls
- branch review requirements
- information reporting requirements
- performance reporting
- continuing education requirements
- proficiency requirements for exchange-traded funds and alternative mutual funds

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Lesson 2: Other Legislation and Regulations

Introduction

As a Dealing Representative, you are subject to legislation and regulations governing Anti Money Laundering and Terrorist Financing (AMLTF), Privacy, and other legislation and regulations. These requirements affect how you interact with your customers, the type of information you collect, and certain reporting responsibilities.

This lesson provides an overview of the legislation and regulations that apply to Dealing Representatives of mutual fund dealers. The Compliance Department of your mutual fund dealer will provide more information about your responsibilities.

This lesson takes approximately 40 minutes to complete.

At the end of this lesson, you will be able to:

- discuss the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)
- discuss the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)
- describe the Dealing Representative's obligations under the PCMLTFA including:
  - identifying clients
  - client due diligence
  - identifying suspicious and large transactions
  - reporting
- explain the Privacy Act and the Personal Information Protection and Electronic Documents Act (PIPEDA)
- define what qualifies as personal information under PIPEDA
- explain the requirements under the Do Not Call List (DNCL)
- explain the requirements under Canada's Anti-Spam Law (CASL)
- explain the requirements under the United States (US) Foreign Account Tax Compliance Act (FATCA)

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Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)

To fight money laundering and terrorist financing, the Parliament of Canada has enacted the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA).

Money laundering is the process used by criminals to convert illicit funds into seemingly legitimate money. Dirty money produced through criminal activity is thus transformed into clean money and the criminal origin of the funds is difficult to trace.

Terrorist financing provides funds for terrorist activities. Terrorist groups/persons “raise” these funds and obscure the links between the funds’ sources and their terrorist activities. The main objective of terrorist activity is to intimidate a population or to pressure a government into a certain course of action.

Securities industry participants, including mutual fund dealers and Dealing Representatives, must comply with the Anti-Money Laundering/Terrorist Financing (AMLTF) requirements codified in the following instruments:

- Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA)
- Proceeds of Crime (Money Laundering) and Terrorist Financing (PCMLTF) Regulations
- Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) Guidance

The objectives of the AMLTF instruments are to:

- implement measures to detect and deter money laundering and terrorist financing
- facilitate the investigation or prosecution of money laundering and terrorist financing offences

Under anti-money laundering/terrorist financing (AMLTF) requirements, firms are responsible for establishing, maintaining, and monitoring an effective AMLTF Compliance Program. Amongst other activities, the firm must:

Anti-Money Laundering Regime	
AMLTF Compliance Officer	• appoint a compliance officer who is responsible for the firm's AMLTF compliance program (note: often called the Chief Anti-Money Laundering Officer (CAMLO))
Policies and Procedures	• establish and maintain policies and procedures for anti-money laundering and terrorist financing including: o "Know Your Client" identification procedures o "Enhanced Measures" for high-risk clients and business areas

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Anti-Money Laundering Regime	
Surveillance & Screening	• conduct surveillance and screening to identify "red flags", violations, and accounts/holdings belonging to suspected money launderers and terrorist groups/persons
Reporting	• file surveillance reports to **FINTRAC** and the **Canada Border Services Agency (CBSA)** for transactions, property, and the importation/exportation of currency or monetary instruments
Training	• provide an ongoing compliance training program for employees, agents, and any other individuals authorized to act on behalf of the firm

Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)

The Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) is Canada's financial intelligence unit for AMLTF. It collects, analyzes, and discloses information to help detect and prevent money laundering and terrorist financing in Canada and abroad. FINTRAC's mandate is to facilitate the detection, prevention, and deterrence of money laundering and terrorist financing in Canada.

Money Laundering

In Canada, money laundering is an offence under the Criminal Code. A money laundering offence is any act to conceal or convert property that is known or believed to be derived from the commission of a crime. A money laundering offence may extend to property derived from illegal activities that took place outside Canada.

Once illegal money has entered into the financial system and is held in cash accounts with financial institutions, a common money laundering method is to purchase securities to further disguise the proceeds of crime.

Terrorist Financing

Under the Criminal Code, a terrorist financing offence consists of knowingly collecting or providing property, directly or indirectly, to carry out terrorist crimes. This includes:

- inviting someone else to provide property for this purpose
- using or possessing property to facilitate or carry out terrorist activities

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While terrorist organizations often raise funds through corrupt activities, they can also raise funds from seemingly harmless, legitimate sources such as:

- donations
- membership dues and subscriptions
- publications
- events

Terrorist financing is used to support terrorist activities carried out by terrorist organizations or cells including:

- making payments to insurgents
- covering the living expenses of terrorist cells
- purchasing weapons, explosives, and equipment for terrorist acts

Your Role

As a Dealing Representative, you are subject to AMLTF legislation and the oversight of FINTRAC. Therefore, you must know and comply with AMLTF requirements and your dealer's policies and procedures for AMLTF.

At minimum, you are responsible for identifying:

- clients (i.e. Know Your Client)
- situations that trigger reporting, such as suspicious and large transactions

Identifying Clients

FINTRAC's Know Your Client (KYC) obligation is meant to ensure that firms "know" the clients they are dealing with. This, in turn, can prevent firms from unknowingly dealing with corrupt individuals and inadvertently allowing illicit funds into the financial system.

At the center of KYC, is your obligation to verify the identity of the client. To do this, you must make a diligent effort to closely examine the client's identification information.

When you deal with a client, you must verify their identity:

1. When you open a **new account** for a client;

2. When certain transactions "trigger" identification.

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When to Verify the Client's Identity
• new accounts • large cash transactions of $10,000 or more • large virtual currency transactions of $10,000 or more • suspicious transactions

Identifying Individuals

The most common method of identifying a client is by examining their government-issued photo identification (ID). When you verify the client's identity, you must ensure that the information in the identification document(s) matches the information provided by the client.

When you identify the client by examining their **government-issued photo identification (ID)**, follow these steps:	
The Identification Document (ID)	The ID document must be issued by: • a province or territory • the federal government • a foreign government
What the ID must Include	The ID must include: • the person's name • the person's photo • a unique identifying number
Verifying the ID	Verify the original ID in the presence of the client. Look to determine whether: • the client's name and appearance **match** • the ID is authentic and valid (look for security features and markers) • the ID is current (look at the expiry date)

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If the Client Cannot be Identified "In Person"	If you cannot verify a client's identity in person, you will need to follow your firm's procedures. These could include video meetings or mobile phone photos combined with authentication technology or facial recognition technology.
Records	Once you have verified the client's ID, record the: • client's name • date you verified the ID • type of ID document used • unique identification number • jurisdiction (province, territory, country) • expiry date

If you cannot identify a client using government-issued photo ID, there are 4 other alternative ways to confirm the identity of a client:

- credit file
- dual-process
- affiliate-member
- reliance

If you need to confirm the identity of a client using one of the alternative methods, you must follow your firm’s policies and procedures and ensure that you maintain records of your verification.

Identifying Entities

When you deal with a client which is an entity, you must:

1. Confirm the existence of the entity;

2. Identify the beneficial owners.

An "entity" is any client that is not an individual person including:

- corporations
- trusts
- partnerships
- funds

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When you confirm the identity of an entity, you will need to follow your firm's policies and procedures. These procedures will likely require you to review the records for the entity (e.g. corporate records, partnership agreement, declaration of trust, articles of association, etc.), confirm the entity's existence, and maintain records of your verification.

Client Due Diligence

In addition to verifying the identity of your clients, there are certain circumstances where you will need to conduct further due diligence to learn more about the client. These include:

- Third-Party Determinations (TPDs)
- Politically Exposed Persons (PEPs)
- Heads of International Organizations (HIOs)

Third-Party Determinations

A third party is a person (or entity) who instructs another person (or entity) to conduct a financial transaction on their behalf.

You must make a third-party determination when you:

- open a new account (including credit cards and prepaid payment products)
- receive large cash transactions of $10,000 or more
- receive large virtual currency (VC) transactions of $10,000 or more

To determine whether there is a third party, ask the client:

- Are they acting at the instruction of another person or entity?
- Will another person or entity be giving instructions on the account?

If the answer to either question is yes, there is a third party. You then need to collect information about the third party as prescribed in your firm's policies and procedures. This will include procedures where you **suspect** there is a third party, but you cannot make a third-party determination.

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In most cases, your firm will require you to record:

- the reason(s) why you suspect that the person (or entity) is acting on behalf of a third party
- whether the person (or entity) indicated that they are acting only on their own behalf

Politically Exposed Persons

Politically Exposed Persons (PEPs) possess access, influence, and control that can make them targets for criminals and terrorists. Because of their status, these individuals can be exploited, knowingly or unknowingly, in money laundering or terrorist financing schemes.

A Politically Exposed Person (PEP) is a person who currently holds, or has held within the last 5 years, one or more of the following offices:

Domestic (Canada)	Foreign	Both Domestic and Foreign
A position/office for the federal government, a provincial/territorial government, or a municipal government including: • Governor General, lieutenant governor, or head of government • member of the Senate, House of Commons, or a legislature • deputy minister or equivalent • president of a corporation that is wholly owned directly by Her Majesty in right of Canada or a province	• head of state or government • member of the executive council of government or legislature • deputy minister or equivalent • president of a state-owned company or a state-owned bank • mayor, reeve, or other similar chief officer of a municipal or local government	• ambassador, or attaché or counsellor of an ambassador • military officer with a rank of general or above • head of a government agency • judge of an appellate court in a province, the Federal Court of Appeal, or the Supreme Court (Canada), or a supreme court, constitutional court, or other court of last resort (foreign) • leader or president of a political party represented in a legislature • family members and close associates of PEPs

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Heads of International Organizations

An international organization is one that:

- is set up by the governments of more than one member country
- has activities in several countries
- is bound by a formal agreement among the member countries
- is an entity that is distinct from the member countries
- has its own legal status

Similar to PEPs, the Heads of International Organizations (HIOs) possess access, influence, and control that can make them targets for criminals and terrorists.

The Head of an International Organization (HIO) is:

- the primary person who leads an international organization (e.g. Chief Executive Officer (CEO), President)
- one who has held the above position/office within the last 5 years
- family members and close associates of HIOs

PEPs and HIOs include the family members and close associates of PEPs and HIOs including:

Family Members	Close Associates
• spouse or common-law partner (including ex-spouse and ex-common-law partner) • children (biological or adopted)	• business partners • business associates who beneficially own or control a business with a PEP/HIO

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Family Members	Close Associates

• parents (mother, father)
• in-law parents of a spouse or common-law partner
• siblings (children of the PEP's parents, e.g. brother, sister)
	• romantic partners (in a romantic relationship with a PEP/HIO)
	• those who:
	  ○ are involved in financial transactions with a PEP/HIO
	  ○ are prominent members of the same political party or union as a PEP/HIO
	  ○ are members of the same board as a PEP/HIO
	  ○ carry out charitable works closely with a PEP/HIO
	  ○ are listed as joint on a policy with a PEP/HIO

Making a PEP/HIO Determination

You must make a PEP/HIO determination when you:

- open a new account (including credit cards and prepaid payment products)
- when you detect a fact about an existing account that indicates a PEP/HIO connection
- conduct periodic monitoring

To determine whether a client is a PEP/HIO, ask the questions prescribed by your firm. These questions are usually spelled out in the firm's application forms and procedures and cover the definitions for PEPs and HIOs above. If you determine that the client is a PEP or HIO, then you need to collect additional information about the transaction.

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PEP/HIO Determination	
Establish the Source	Establish the source of the: • funds or virtual currency (VC) being deposited • PEPs/HIOs wealth
Obtain Approval	Obtain approval from a member of senior management to open the account/keep the account open.
Enhanced Measures	Be diligent when you verify to client's identity. Take any enhanced measures that are prescribed by your firm for PEPs/HIOs.
Records	Once you have made your PEP/HIO determination, you need to collect and record the: • PEP/HIO's office/position • name of the organization/institution • date of your determination • source of funds/VC • source of wealth • name of senior management member who approved the account/transaction • date of approval
Firm's Policies and Procedures	Your firm will also need to implement ongoing monitoring and enhanced measures for any accounts they accept from PEPs and HIOs. Make sure that you are aware of your firm's procedures and follow them closely!

When You Cannot Identify a Client

If you cannot confirm a client's identity, you must decline to open the account. In the case of corporations, you must close the account and you may not conduct any subsequent transactions.

Identifying Suspicious and Large Transactions

Identifying and reporting suspicious and large transactions is another important part of your AMLTF duties. When you identify and report suspicious and large transactions, you become a key player in the detection and prevention of money laundering and terrorist financing.

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You, as a Dealing Representative, are the person with the face-to-face, front-line relationship with clients. Therefore, you are in the best position to identify persons and transactions that are suspicious in terms of money laundering and terrorist financing. As such, the onus for identifying suspicious transactions falls largely on you.

What is considered suspicious?

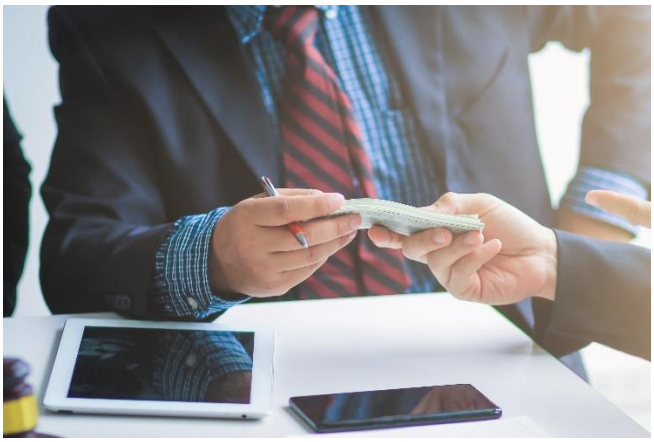
When there are reasonable grounds to suspect that a transaction is related to the commission of money laundering and/or terrorist financing, it is a **suspicious transaction**.

What are the indicators?

When a transaction seems odd or does not make sense, is overly complex, or gives rise to misgiving or mistrust, you may suspect that something is not right.

Some common indicators of suspicious transactions can be from clients who:

- deposit cash
- transact through offshore accounts
- use large transactions



What are large transactions?

You must also report any large-value transactions including:

- large cash transactions of $10,000 or more*
- large virtual currency transactions of $10,000 or more*
- international electronic funds transfers (EFTs) of $10,000 or more*

* This also includes multiple transactions for any of the above, with a combined value exceeding $10,000 within 24 hours.

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Reporting

When you identify a "red flag" that suggests a transaction is suspicious or large, **report the matter to your firm as soon as possible** according to your firm's procedures. It is critical that you do nothing to “tip” the client that you suspect anything or that you are making a report.

Even if only an attempt is made and the transaction is not completed, you must still report it to your firm and you must still ensure that you do nothing to “tip” the client that a report will be made.

Privacy Legislation

In your role as a Dealing Representative, it is your duty to collect personal information from your client. You have an obligation to keep that information confidential. The collection, use, and disclosure of an individual's personal information are protected by legislation.

To protect personal information, the Federal Government has enacted the Privacy Act and the Personal Information Protection and Electronic Documents Act (PIPEDA). Other provincial privacy acts also provide additional protection for personal information.

Privacy legislation establishes rules on how governments and private sector organizations may collect, use, or disclose personal information. The legislation also gives individuals several rights, including:

- the right to consent to the collection, use, or disclosure of personal information about them
- the right to access the personal information which governments and private sector organizations have collected about them
- the right to request the correction of errors and omissions in their personal information

Governments and private sector organizations, including mutual fund dealers and other securities registrants, have several obligations under privacy legislation.

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Personal Information Protection and Electronic Documents Act (PIPEDA)

PIPEDA is Canada's private-sector privacy law. PIPEDA establishes rules for how federally regulated private sector organizations may collect, use, or disclose personal information. Mutual fund dealers are generally subject to *PIPEDA*. However, *PIPEDA* does not apply in provinces that have enacted similar legislation (Québec, Alberta, and British Columbia). Even where provincial legislation has been enacted, the sharing of personal information across provincial, territorial, or international borders is governed by *PIPEDA*.

Summarized below is an overview of PIPEDA requirements.

Overview of PIPEDA Requirements
1. Personal information about individuals must be collected for a reasonable purpose.
2. If an organization wants to collect, use, or disclose personal information about individuals, it must obtain their consent.
3. An organization can only use or disclose personal information about individuals for the purpose consented to by the individual.
4. Even with consent, an organization must limit the collection, use, and disclosure of personal information to purposes that a reasonable person would consider appropriate under the circumstances.
5. Individuals have a right to see the personal information that an organization holds about them and to correct any inaccuracies.
6. Organizations must store personal information about individuals securely and must have safeguards to protect it.
7. The Privacy Commissioner of Canada has oversight to ensure that privacy law is respected and redress is made if individuals' rights are violated.

PIPEDA does not apply to:

- any government institution to which the Privacy Act applies
- someone who collects, uses, or discloses personal information strictly for personal purposes (for example, the collection of names and addresses for a wedding invitation list)

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- an organization that collects, uses, or discloses personal information for journalistic, artistic, or literary purposes and does not do so for any other purpose

Other Provincial Privacy Acts

Alberta, British Columbia, Québec, and Ontario (only concerning personal health information held by health information custodians) have privacy laws that have been recognized by the Federal Government as substantially similar to PIPEDA.

When operating within one of those jurisdictions, organizations are subject to the provincial privacy legislation instead of PIPEDA, and to the authority of the provincial privacy commissioner.

What is Personal Information

PIPEDA has rules governing what private sector organizations can do with "personal information". Personal information is defined as “information about an identifiable individual”. Individual means “a natural person”. Therefore, a corporation is not an individual. PIPEDA requirements apply to all individuals including those who are not Canadian citizens, residents of a specific province, or adults.

Personal information excludes the information you would expect to find on a business card such as:

- name
- business title
- business address
- business telephone number of any employee

Personal information includes:

PERSONAL INFORMATION
General
• name • date of birth • address • telephone number • gender • physical description • identification numbers (e.g. social insurance number) • income • education • employment

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- blood type
- credit records
- loan records
- existence of a dispute between a consumer and a merchant
- intention to acquire goods or services
- visual images and videotapes where individuals may be identified

Information of a Sensitive Nature

- health or medical history
- racial or ethnic origin
- political opinions
- religious beliefs
- trade union membership
- sexual orientation
- opinions about the individual

Personal information includes **both**:

- information stored in paper form
- information stored in electronic format

Personal information held by a Mutual Fund Dealer

A mutual fund dealer holds a fair amount of personal information about its clients, usually collected by their Dealing Representatives for the purpose of the Know Your Client rule. Personal information is usually contained in:

- New Client Application Forms (NCAFs)
- Know Your Client (KYC) Forms
- information collected under anti-money laundering and terrorist financing legislation
- information collected for the purpose of the US *Foreign Account Tax Compliance Act* (*FATCA*)
- trading records
- client account statements
- cheques
- financial records

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Impact of Privacy Legislation on the Role of SROs

The SROs cannot be restricted from access to personal information about clients under privacy legislation. Since the SROs need access to personal information about clients to fulfill their regulatory obligations, they issued a *Joint Regulatory Notice on Federal and Provincial Privacy Legislation* (the *"Joint Notice"*) which imposes the following requirements:

- In their defined "purpose" for collecting, using, and disclosing personal information, dealers must state that personal information may be disclosed to the Canadian Investment Regulatory Organization (CIRO), and CIRO may use and disclose the personal information for regulatory purposes including those listed in the *Joint Notice.*

- If an individual does not consent to the disclosure of personal information to CIRO and its use and disclosure by them, the dealer must not accept or administer the related account.

Do Not Call List (DNCL)

The National Do Not Call List (DNCL) is administered by the Canadian Radio-television and Telecommunications Commission (CRTC). The CRTC has the authority to levy penalties on offenders.

The intention of the National DNCL is to give consumers the choice about whether to receive telemarketing calls. Telemarketing refers to unsolicited telecommunications to sell or promote a product or service. Mutual fund dealers are also required to maintain their own DNCL and individuals can ask to be put on the dealer's DNCL. The DNCL telemarketing restrictions apply to those individuals listed on the National DNCL or the dealer's DNCL (together called the "DNCL").

When an individual signs up to have their home phone, mobile, or fax number included on the DNCL, telemarketers are not allowed to make unsolicited marketing or sales calls to the number.

You and your dealer are free to call numbers for marketing or sales purposes as long as they are not on the DNCL. It is, of course, also permissible to call existing clients about the existing services you provide, even if they are on the DNCL. Depending on your relationship, the client could expect to be contacted regarding investment advice, changing market conditions, or queries to meet regulatory requirements. You and your dealer are also allowed to continue calling clients up to 18 months after a client has ceased to do business with you. However, unsolicited calls to offer new services or products are not permitted if they are on the DNCL.

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As a Dealing Representative, it is important for you to be familiar with your dealer's policies and procedures regarding the DNCL and to follow them. At the very least, you will be prohibited from making unsolicited marketing or sales calls to numbers that are on the DNCL. This prohibits you from cold-calling possible new clients and former clients who have not done business with you in the last 18 months if they are on the DNCL.

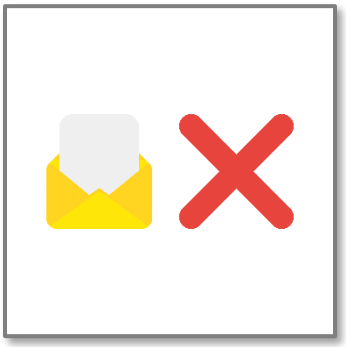
Canada's Anti-Spam Legislation (CASL)

Canada's Anti-Spam Law (CASL) is designed to regulate the transmission of commercial electronic messages (CEMs), also referred to as spam. Under the Electronic Commerce Protection Act (ECPA), senders must obtain pre-consent from individuals before they may send them a CEM. In addition to CEMs, CASL deals with other electronic threats to commerce, such as malware, spyware, pretexting, and the harvesting of electronic addresses and personal information.

What is a commercial electronic message (CEM)?

The concept of a commercial electronic message (CEM) is central to CASL. CEMs are essentially emails or other electronic messages that contain commercial or promotional information to encourage participation in a commercial activity. CEMs also include electronic messages that contain a request for consent to send messages.

CASL prohibits organizations, including registered firms and individuals, from sending CEMs to consumers unless all of the following conditions are met:



- the recipient has consented to receive the message
- the message includes information that identifies the sender
- the message enables the recipient to withdraw consent and unsubscribe from all future messages

While organizations are permitted to provide consumers with the option to unsubscribe from only certain types of messages, they must also provide consumers with the option to unsubscribe from all future messages.

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Summarized below is an overview of CASL requirements.

Overview of CASL Requirements	
Recipient must Opt In	• Recipients must positively opt in to receiving CEMs from the organization • Organizations cannot send CEMs to recipients who have not consented to receive the CEMs by opting in
Recipient Consent	• The recipient's consent to receive CEMs may be express or implied • Pre-checked boxes cannot be used to obtain express consent • Recipients must take some positive action to indicate consent, such as checking a blank box
Penalties	The CRTC has the authority to impose administrative monetary penalties for violations of CASL: • Maximum penalty for individuals: $1 million • Maximum penalty for organizations $10 million • Possible damages and statutory damages for businesses • Possible liability for directors and officers

As a Dealing Representative, it is important for you to familiarize your dealer's policies and procedures regarding CASL. As a general rule, you will be prohibited from sending CEMs to recipients who have not opted in to receive them.

Referral Exemption

The ECPA permits an exemption to the CEM pre-consent rules for referrals. A sender is permitted to send one CEM to a recipient without prior consent provided that the sender:

- was referred to the recipient by another individual who has an existing business relationship with the recipient
- discloses the full name of the individual(s) who made the referral

The Foreign Account Tax Compliance Act (FATCA)

The government of the United States (US) has long been concerned that certain US taxpayers were evading the payment of taxes by investing offshore. The US Foreign Account Tax Compliance Act (FATCA) targets those taxpayers.

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FATCA requires foreign financial institutions, including firms in the Canadian financial sector, to report about:

- financial accounts held by US taxpayers
- foreign entities in which US taxpayers hold a substantial ownership interest

If a Canadian financial institution does not comply with FATCA, it faces a 30% withholding tax on certain US-source payments made to it. This is extremely punitive and constitutes a powerful incentive to comply.

To facilitate compliance with FATCA, the Canadian and US governments have entered into an Inter-Governmental Agreement (IGA) which has been incorporated into Part XVIII of the Income Tax Act of Canada (ITA).

Under Part XVIII of the ITA, Canadian financial institutions, including mutual fund dealers, must:

- identify accounts held by clients who are US persons for US tax purposes
- report to the Canada Revenue Agency (CRA) specified information about the accounts identified as being held by US persons

Identifying US Persons

In general, a person is a US person for US tax purposes if that person is a US resident or a US citizen. However, a person who has economic and social ties that are closer to Canada than the US would not generally be considered to be a US resident.

Existing Clients

In order to identify existing clients under FATCA, Canadian financial institutions must review information already in their possession for indications that the client may be a US person, for example a US address. If there is such an indication, the Canadian financial institution must ask the client to certify whether they are a US person. The client may be asked to provide supporting documentation if they claim not to be a US person.

New Clients

To identify new clients under FATCA, Canadian financial institutions must ask clients to certify whether they are a US person at the time that the account is opened. The firm must then confirm the reasonableness of the client's certification based on the other information provided by the client when opening the account.

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Alternatively, the firm may follow a process similar to that described above for existing clients, based on the information provided by the client when the account is opened.

Failure to Cooperate

If a Canadian financial institution has information in its records that shows that a client may be a US person, and the client refuses to cooperate in clarifying their status, the firm must report the account as a US account to the Canada Revenue Agency (CRA). CRA will report information about the account to the US Internal Revenue Service (IRS).

Accounts Identified as US Persons

For accounts identified as being held by US persons, Canadian financial institutions (including mutual fund dealers) must report the following information to CRA:

- information about the account holder (e.g. name, address, the individual's US taxpayer identification number)
- certain financial information about the account

CRA, in turn, will automatically report the information to the IRS.

By complying with Part XVIII of the ITA, Canadian financial institutions avoid being exposed to the punitive 30% withholding tax under FATCA.

As a Dealing Representative, you should familiarize yourself with your dealer's policies and procedures regarding FATCA. You may have responsibilities for identifying clients who are US persons, particularly at the time of account opening.

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Summary

Congratulations, you have reached the end of Unit 1: Regulatory Environment.
In this unit you covered:

- Lesson 1: Regulatory Bodies and Securities Legislation
- Lesson 2: Other Legislation and Regulations

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 1 **Quiz** button.

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Unit 2: Registrant Responsibilities

Introduction

Participants in the investment industry are expected to observe high standards of ethics and conduct in their dealings with the investing public. This unit covers the principles of ethics and your regulatory obligations concerning standard of conduct.

This unit takes approximately 2 hours to complete.

Lessons in this unit:

- Lesson 1: Ethics and Standard of Conduct
- Lesson 2: Compliance
- Lesson 3: Conflicts of Interest
- Lesson 4: Compliance Issues and Prohibited Practices
- Lesson 5: Registration Requirements

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Lesson 1: Ethics and Standard of Conduct

Introduction

Dealing Representatives are expected to observe high standards of ethics and conduct in their dealings with their clients. This lesson covers the principles of ethics, ethical standards, and your standard of conduct obligations.

This lesson takes approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- explain ethics and ethical standards
- define and describe your regulatory obligations concerning standard of conduct
- discuss how good compliance is good business
- provide examples of proper conduct and improper conduct
- explain breaches, consequences, disciplinary measures, and penalties

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Ethics

What is Ethics?

Ethics is a set of guiding philosophies and principles that epitomize proper conduct and behaviour. Ethical conduct is based on moral values which exemplify what is right and what is wrong.

Ethics goes beyond simply following rules and complying with laws. Ethics encompasses the consideration of those aspects that are undefined and not formally prescribed, and in so captures the intended "spirit" of ethical conduct.

Values versus Laws

Official status has been legislated in the form of laws for many of the values we consider most important, such as those concerning property and theft. The practical implication of recognizing a value as a law is that the breach of a law has important consequences for wrongdoers. In the case of criminal offences, consequences may be in the form of fines or imprisonment.

Ethical Standards

Distinguishing what constitutes ethical behaviour cannot be prescribed and made into laws for every possible situation. When making an ethical judgment, people often turn to a checklist similar to the one below.

10-Point Ethics Checklist[2]

1. ***The Golden Rule:*** Would I want people to do this to me?
2. ***The Fairness Test:*** Who might be affected and how? Is this fair to everyone?
3. ***The "What if everybody did this?" Test:*** Would I want everyone to do this? Would I want to live in that kind of world?
4. ***The Truth Test:*** Does this action represent the whole truth and nothing but the truth?
5. ***The Parents Test:*** How would my parents feel if they found out about this? What advice would they give me?
6. ***The Children Test:*** Would I be willing to explain everything about this to my kids and expect them to act in the same way?

[2] Source: Darrin Clement

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10-Point Ethics Checklist[2]

7. ***The Religion Test:*** Does this go against my religion?
8. ***The Conscience Test:*** Does this go against my conscience? Will I feel guilty?
9. ***The Consequences Test:*** Are there possible consequences of this action that would be bad? Would I regret doing this?
10. ***The Front Page Test:*** How would I feel if the action was reported on the front page of my hometown newspaper?

Ethical Conduct in the Securities Industry

In the securities industry, maintaining high ethical standards serves to protect investors and also serves to protect the reputation of firms, individuals, and the securities industry as a whole. Ethical conduct is guided by the requirements established in securities legislation and regulations. These requirements are rooted in the specific realities of the investment industry, in particular, the paramount need for trust and honesty.

Example

The Ontario Securities Commission's (OSC) statutory mandate is to:

- provide protection to investors from unfair, improper or fraudulent practices;
- foster fair, efficient and competitive capital markets and confidence in the capital markets;
- foster capital formation; and
- contribute to the stability of the financial system and the reduction of systemic risk.

Promoting and fostering ethical behaviour by market participants is an important part of the OSC's vision of being an effective and responsive securities regulator, fostering a culture of integrity and compliance, and instilling investor confidence in the capital markets.

As with all rules and laws meant to govern ethical conduct, ethical behaviour cannot be prescribed for every possible situation. One might consider the following questions when considering whether conduct is ethical:

- Is the action legal?
- Does it conform to the firm's policies?
- Would I be embarrassed if my supervisors, colleagues, clients, family, or friends knew all the details?
- How would the public view the conduct if it was reported in the news?
- Would the practice likely be an accepted industry practice?

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- Would I approve if others acted in the same way?
- How would I feel if this happened to me?
- Am I compromising my personal ethics in any way?
- Does the action make me feel uncomfortable?

The answer to any of the above questions can help determine whether the conduct can seriously be considered ethical.

Securities law is comprised of:

- a principles-based obligation for ethical conduct, and
- specific business conduct requirements.

Standard of Conduct

Participants in the investment industry are expected to observe high standards of ethics and conduct in their dealings with the investing public. Most important are the ethical principles of trust, integrity, fairness, and honesty. These standards and principles are instilled into the securities laws of each province and territory and the rules and regulations of the provincial and territorial securities commissions, the self-regulatory organizations (SROs), and the Canadian Securities Administrators (CSA).

Ontario Securities Commission (OSC) Rule 31-505, Section 2.1 states:

"**2.1 General Duties**

(1) A registered dealer or adviser shall deal fairly, honestly and in good faith with its clients.

(2) A representative of a registered dealer or registered adviser shall deal fairly, honestly and in good faith with his or her clients."

References to dealing “fairly, honestly and in good faith with clients" have been included in the rules and regulations of all the securities regulators in Canada.

Companion Policy (CP) 31-103, Registration Requirements

Under Companion Policy (CP) 31-103, Part 1.3 (Fitness for Registration (b) Integrity) it states:

"Registered individuals must conduct themselves with integrity and have an honest character."

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Further in CP 31-103, under Part 11.1 (Compliance System (a) Day-to-Day Monitoring) it states:

"Anyone who supervises registered individuals has a responsibility on behalf of the firm to take all reasonable measures to ensure that each of these individuals:

- deals fairly, honestly and in good faith with their clients
- addresses conflicts of interest in the best interest of their clients
- puts the client's interests first when making suitability determinations for their clients
- complies with securities legislation
- complies with the firm's policies and procedures, and
- maintains an appropriate level of proficiency."

Canadian Investment Regulatory Organization (CIRO) Mutual Fund Dealer (MFD) Rule 2.1.1, Standard of Conduct

Mutual Fund Dealer (MFD) Rule 2.1.1 outlines the standard of conduct for ethical behaviour for you, as a Dealing Representative. You are expected to:

- deal fairly, honestly, and in good faith with clients
- observe high standards of ethics and conduct in the transaction of business
- not engage in any business conduct or practice which is unbecoming
- not engage in any business conduct or practice which is detrimental to the public interest
- be of proper character and have proper business repute
- have appropriate experience and training

The expectation that you will adhere to the standard of conduct applies not only to the letter of the regulation but also to the spirit of the regulation as well.

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Good Compliance is Good Business

It is a fundamental principle that you, as a Dealing Representative, deal fairly, honestly, and in good faith with your clients. Far from being strictly a regulatory requirement, this standard of conduct makes good business sense. Even in the absence of a regulatory requirement, Dealing Representatives should exercise a high standard of conduct to:

- protect their reputation and that of the industry as a whole
- attract and retain clients
- be successful in the long as well as the short term

Below are some examples of practices that observe high standards of conduct.

Examples of Proper Conduct

- fully understanding the financial circumstances of clients
- presenting all investment recommendations fairly and without false or misleading statements
- always making recommendations in the best interests of the client
- clearly distinguishing fact from opinion when making recommendations
- protecting the confidentiality of client information
- maintaining proficiency and staying informed about new investment products, financial markets, laws, and regulations

Many of these practices have been codified into the specific rules and regulations of the securities regulators.

Breaches and Consequences

Because integrity is mandated by securities law, failure to behave in an ethical manner will result in negative consequences. Dealers, securities commissions, CIRO, and other regulatory bodies have the authority to discipline industry participants who engage in improper conduct.

Below are some examples of improper conduct.

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Examples of Improper Conduct

- trading in securities without being registered
- making unsuitable recommendations including failing to observe the Know Your Client (KYC) and Know Your Product (KYP) rules
- inadequate handling of conflicts of interest including lack of disclosure
- failure to observe suitability and disclosure requirements when recommending the use of leverage
- lack of disclosure of referral arrangements
- failing to disclose and obtain pre-approval for outside activities
- misleading marketing materials

Disciplinary Measures and Penalties

Under securities regulation, dealers are required to establish disciplinary measures to remedy infractions to their internal policies and procedures and misconduct by their Dealing Representatives and registrants. Under self-regulation, dealers have the authority to impose disciplinary measures and penalties on those who commit breaches or misconduct. In addition, dealers are also required to report certain offences to CIRO via its complaints and events tracking systems or upon termination of the Dealing Representative. If you commit a significant breach, CIRO will know about it from your dealer.

CIRO, the provincial/territorial securities regulators, and the Financial Transactions and Report Analysis Centre of Canada (FINTRAC) all have the authority to discipline Dealing Representatives who commit violations. Dealing Representatives who transgress the rules exposes themselves to a range of penalties including fines, suspension, and permanent prohibition. FINTRAC penalties can include criminal charges (through disclosure to law enforcement) or administrative monetary penalties. The provincial/territorial securities regulators also have the authority to prosecute and seek sanctions and penalties through the courts.

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Lesson 2: Compliance

Introduction

All mutual fund dealers are required to establish a compliance regime that adheres to securities legislation. This lesson provides information about the role and responsibilities of a mutual fund dealer's Compliance Department, and how the compliance function and processes support you as a Dealing Representative.

This lesson takes approximately 25 minutes to complete.

At the end of this lesson, you will be able to:

- discuss the Compliance regime of a mutual fund dealer
- describe the role of the Compliance Department, Ultimate Designated Person (UDP), and Chief Compliance Officer (CCO)
- explain the requirements under the client relationship model (CRM) and the client focused reforms (CFR)
- explain the requirements for Relationship Disclosure Information (RDI)
- explain the requirements for Client Communications

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The Compliance Regime

All mutual fund dealers are required to establish, maintain, and apply a system of controls and supervision to ensure that the firm complies with securities legislation and manages the risks associated with its business. This system is known as the compliance regime.

While the primary goal of the compliance regime is to ensure adherence to legislative and regulatory requirements, the other essential aspect of compliance is effective risk management, with the objective of identifying potential risks and proactively developing strategies to mitigate them.

Responsibility for Compliance

A common misconception is that compliance is an isolated activity of the Compliance Department. In fact, compliance is a firm-wide responsibility. Everyone within a registered firm, whether they are registered individuals or not, has a responsibility to observe high standards of conduct and to comply with applicable legislation and regulations.

Compliance Roles and Responsibilities

Registered firms, including mutual fund dealers, are required to establish a compliance regime, system, policies, and procedures, and appoint senior officials to oversee and maintain the compliance function. All registered firms are responsible for:

- the firm's compliance with regulatory requirements
- designating the firm's Ultimate Designated Person (UDP) and Chief Compliance Officer (CCO)

The Ultimate Designated Person (UDP) is the most senior person in the firm's compliance regime. Requirements dictate that the UDP must be the firm's Chief Executive Officer or similar capacity of authority. The UDP is responsible for promoting a culture of compliance and overseeing the effectiveness of the firm's compliance system.

The Chief Compliance Officer (CCO) is the senior operating officer responsible for compliance activities. The CCO is responsible for:

- overseeing the activities for monitoring and assessing the firm's compliance with regulatory requirements
- reporting to the UDP and the Board of Directors (or equivalent) on matters of compliance
- submitting an annual report to the Board of Directors detailing the assessment of the firm's compliance with securities legislation

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The Compliance Department's major role is to monitor, identify, and assess the registered firm's compliance with regulatory requirements. The Compliance Department is also responsible for communicating, escalating, reporting, and advising on the effectiveness of the registered firm's compliance system in meeting regulatory requirements and risk management objectives.

Example

Giovanni is a Dealing Representative who joined his dealer from another firm six months ago. Giovanni's new firm finds that he has advised his clients to leverage their accounts, even when it was not appropriate.

When the firm's Compliance Department detects this activity, they perform suitability reviews for all his leveraged clients. For those accounts determined to be unsuitably leveraged, the firm requires Giovanni to unwind the accounts and compensate the clients for any losses suffered. The firm also issues a Warning Letter to Giovanni about their findings of unsuitable leverage.

If Giovanni were to continue these activities after the firm's warning, the Compliance Department could take stronger action such as additional training, close supervision, and in extreme cases, termination.

Example

While Giovanni's firm has decided to permit investing with leverage, they have implemented compliance systems to monitor leverage activity. The purpose of the monitoring systems is to prevent and detect inappropriate leverage activity and manage risks to the firm. Other firms may take even stronger measures and make the decision to disallow leveraged investing.

How the Compliance Department Supports the Firm and Dealing Representatives

The Compliance Department performs a vital business function for the firm by:

- conducting new account, trade, and other supervision reviews
- monitoring the activities of Dealing Representatives to assess whether:
  - the activities meet regulatory requirements and the firm's policies and procedures
  - conflicts of interest are properly addressed or avoided

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- educating and training Dealing Representatives to allow them to maintain, grow, and protect their business in a compliant manner

- assistance to Dealing Representatives to help them manage risks to their reputation and business operations

- advice to Dealing Representatives in situations where they are in doubt or aren't sure of the right course of action

The Compliance Department is an integral part of the firm's overall risk management regime. The main objective of risk management within a mutual fund dealer is to protect and preserve the firm's capital and earnings from losses.

The Compliance Department can also be a good resource when you need to seek guidance. When faced with an unfamiliar situation concerning regulatory requirements or the firm's compliance policies and procedures, you can and should ask your Compliance Department for advice.

Client Relationship Model (CRM) and Client Focused Reforms (CFR)

Under the Client Relationship Model (CRM), harmonized legislation has been enacted under National Instrument (NI) 31-103 (Registration) and the Rules of the Canadian Investment Regulatory Organization (CIRO) governing:

- Relationship Disclosure Information (RDI)
- Conflicts of Interest
- Enhanced Suitability Assessment
- Reporting to Clients

Further amendments to the rules and legislation concerning conflicts of interest, suitability, and Relationship Disclosure Information (RDI) have since been enacted under the Client Focused Reforms (CFR).

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Client Relationship Model (CRM) and Client Focused Reforms (CFR)	
Relationship Disclosure Information (RDI)	• CRM introduced the Relationship Disclosure Information (RDI) requirement. • The RDI must be provided to clients to provide them with key information about the account they open at the time they open the account. • The standards for Relationship Disclosure Information (RDI) have since been amended further under the Client Focused Reforms (CFR) which requires registrants to: - include specific disclosure about conflicts of interest - disclose the registered firm's obligation to put the client's interests first when making a suitability determination
Conflicts of Interest	• CRM introduced higher standards for the treatment of conflicts of interest which established that conflicts of interest must be: - addressed in a fair, equitable, and transparent manner, consistent with the best interests of the client • The standards for the treatment of conflicts of interest have since been amended further under the Client Focused Reforms (CFR) which require that registrants must: - address all material conflicts of interest in the best interest of the client - avoid all material conflicts of interest where the conflict cannot be addressed in the best interest of the client

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Client Relationship Model (CRM) and Client Focused Reforms (CFR)	
Enhanced Suitability Assessment	• CRM introduced new standards and suitability "triggers" for assessing the suitability of investment products and strategies. • The standards for Know Your Client, Know Your Product, and Suitability Determination have since been amended further under the Client Focused Reforms (CFR) which requires registrants to: - put the client's interests first when making a suitability determination - disclose, in the Relationship Disclosure Information (RDI) provided to clients, the registered firm's obligation to put the client's interests first when making a suitability determination
Reporting to Clients	• CRM introduced new standards for reporting to clients: - Trade Confirmations: must be issued to clients for each trade and must include prescribed details about the costs and charges. - Account Statements: must be issued to clients on a quarterly basis and in each month that there is activity in the account, and must include prescribed details about position cost, market value, deferred sales charge (DSC)[3] indicators, and other information and disclosures. - The Report on Charges and Compensation: must be issued to clients annually and must provide clients with easy-to-understand information about the amounts, in dollars and cents, of the charges and compensation paid to the dealer. - The Performance Report: must be issued to clients annually and must provide clients with easy-to-understand information about the cost-adjusted performance return of their investments following prescribed standards.

[3] Effective June 1, 2022, DSC Funds are banned in all jurisdictions. However, DSC Funds distributed prior to the ban may be held by investors and associated redemption schedules may apply.

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Client Relationship Model (CRM) and Client Focused Reforms (CFR)	
Pre-Trade Cost Disclosure	• CRM introduced the new standard for pre-trade cost disclosure. - Registered individuals, including the Dealing Representatives of mutual fund dealers, are required to disclose the costs associated with the purchase or sale of a security before the transaction is made - whether there are any fund management expense fees or other ongoing fees that the client may incur in connection with the security

As with all other market participants, mutual fund dealers and their Dealing Representatives are subject to the regulatory requirements established under the Client Relationship Model and Client Focused Reforms.

Relationship Disclosure Information (RDI)

The objective of the relationship disclosure requirement is to ensure that clients:

- understand their obligations and those of the mutual fund dealer
- know what to expect with respect to products, service levels, and costs

The Relationship Disclosure Information (RDI) requirements are established in:

- National Instrument (NI) 31-103, s. 14.2, (k), Relationship Disclosure Information
- Mutual Fund Dealer Rule 2.2.7, Relationship Disclosure Information

When a new account is opened for a client, your mutual fund dealer is required to provide written disclosure of the Relationship Disclosure Information (RDI). As a Dealing Representative, you are expected to provide the RDI to your clients, discuss the RDI information with them, and be prepared to answer any questions.

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The RDI will include, at minimum, the following elements:

Relationship Disclosure Information (RDI)	
RDI Section	**Description**
Account Type	• describes the nature/type of account • includes an explanation of how and where the client's assets are held
Advisory Relationship	• describes the nature of the advisory relationship • establishes responsibility for investment advice and investment decisions
Products & Services	• describes the products and services provided by the registered firm • provides specific disclosure about: - liquidity and resale restrictions - investment fund management expense fees and ongoing fees - other ongoing fees and expenses - proprietary products - investment funds of a related investment fund manager
Cash & Cheques	• describes how the registered firm receives and handles deposits and cheques from clients • establishes who the payee is for deposits and cheques
Risks	• describes the risks that a client should consider when: - making investment decisions - borrowing to invest
Conflicts of Interest	• describes the conflicts of interest that the registered firm is required to disclose to the client

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Relationship Disclosure Information (RDI)	
RDI Section	**Description**
Suitability	• describes the registered firm's suitability obligation including: - the events that will trigger a suitability assessment - the obligation to put the client's interest first when determining suitability
Know Your Client (KYC)	• defines the terms for the KYC information collected • describes how the KYC information will be used in relation to specific investments that may be recommended or accepted for the client's account • describes how the KYC information will be used when assessing suitability
Client Reporting	• describes the frequency and content of reporting that will be sent to the client for: - Trade Confirmations - Client Account Statements - Report on Charges and Other Compensation - Performance Report
Compensation and Benefits	• describes the nature of compensation that the firm may receive, for example: - commissions at the time of purchase - trailer fees on an ongoing basis • refers to other sources for more specific information on compensation • describes the benefits to the firm from other parties in connection with the client's investment with the firm
Transaction Charges	• describes the types of transaction charges that the client may be required to pay

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Relationship Disclosure Information (RDI)	
RDI Section	**Description**
Impact on Returns	• explains the impact on a client's investment returns from: - expenses and ongoing fees (described under Products and Services) - charges (described under Transaction Charges) • includes the effect of compounding over time
Benchmarks	• explains how investment performance benchmarks might be used to assess the performance of the client's investments • provides investment performance benchmarks available from the firm
Complaint Obligations	• describes the firm's obligations with respect to complaints and the process for pursuing recourse with the Ombudsman for Banking Services and Investments (OBSI)

When you open a new account for a client, you are required to provide and explain the Relationship Disclosure Information (RDI). You are responsible for helping the client understand the nature of the relationship between you, your firm, and the client.

Under the RDI requirements, you are expected to:

- spend sufficient time with your clients to explain the RDI information
- discuss the RDI information with your clients in an in-person or telephone meeting
- be prepared to answer any questions
- follow their firm's policies and procedures to evidence that you have done so

You are expected to go through the RDI with your client at the beginning of your relationship to ensure that the client understands the information in the RDI. It may also be a good practice to re-visit the RDI with the client in subsequent meetings (e.g. in regular meetings or in subsequent meetings to discuss new investment products).

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Setting Expectations

As part of the relationship discussion, you should discuss expectations and encourage the client to actively participate in the relationship. You should encourage clients to:

- **Keep you and your dealer up to date about their Know-Your-Client (KYC) information**. Clients should be encouraged to promptly notify you or your dealer about any change to their information that could result in a change to the types of investments appropriate for them, such as a change to their personal circumstances, financial circumstances, investment needs and objectives, risk profile, or time horizon.

- **Be informed about their investments**. Clients should be encouraged to fully understand their investments by asking questions, consulting professionals, and carefully reviewing the literature provided to them.

- **Stay informed about their investments.** Clients should be encouraged to review all account documentation provided to them and to regularly review portfolio holdings and performance. Clients should also be encouraged to request information from the dealer if they have concerns about their accounts, transactions, their relationship with the dealer, or their relationship with you.

Maintaining Evidence of Relationship Disclosure

You are required to maintain evidence that the RDI has been provided to your clients. If the relationship disclosure is incorporated into the New Client Application Form (NCAF) or account documentation and it is signed by the client, a copy of the relevant document in the client file is sufficient evidence.

If the relationship disclosure is provided as a stand-alone document, evidence of delivery may include:

- a signed client acknowledgement

- a copy of the RDI in the client file accompanied by detailed notes about the client meeting including that the RDI was provided

Disclosure and Transparency

All disclosures provided to a client must be:

- **Accurate** – the disclosure must be accurate and up-to-date

- **Complete** – the disclosure must contain all material information and must not have any omissions of material information

- **Clear and understandable** – the disclosure provided to a client must be clear and understandable (e.g. plain language)

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- **Relevant and useful to the client** – the disclosure must be relevant to the client's specific circumstances (e.g. relevant to the client's type of account)

- **Timely** – the timing of the disclosure must permit the client to act upon the information where necessary. Specifically, disclosure of conflicts of interest in respect of a particular transaction should be provided to the client before the transaction so the client can decide whether or not to proceed with the transaction.

Client Communications

Client communications are defined as any written communication provided by a mutual fund dealer or Dealing Representative to a client including trade confirmations and account statements, other than advertisements or sales communications.

Client communications must **not**:

- be untrue or misleading
- make unwarranted or exaggerated claims
- be detrimental to the interests of the client
- violate any law or regulation
- be inconsistent or confusing in the information provided

There are specific rules dealing with how rates of return may be communicated. The rules also require that any client communication containing or referring to a rate of return must be approved by a designated person(s) at your mutual fund dealer.

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Lesson 3: Conflicts of Interest

Introduction

In this lesson you will learn about conflicts of interest and your responsibilities to identify and manage those conflicts.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of conflicts of interest
- define conflict of interest
- explain the criteria to be considered when determining whether a conflict is material
- discuss how conflicts of interest must be identified
- discuss how conflicts of interest must be addressed
- provide an overview of common conflicts of interest

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Conflicts of Interest

All registrants in the Canadian capital markets have a duty to identify and address conflicts of interest. The obligations concerning conflicts of interest permeate throughout all levels of securities legislation and regulations including:

- National Instrument (NI) 31-103, s. 13.4, 13.4.1, *Identifying, Addressing, and Disclosing Material Conflicts of Interest*
- Mutual Fund Dealer Rule 2.1.4, *Identifying, Addressing and Disclosing Material Conflicts of Interest*

Further interpretation and guidance is provided in:

- Companion Policy (CP) 31-103, s. 13.4, 13.4.1, *Identifying, Addressing, and Disclosing Material Conflicts of Interest*

The overriding theme in the regulatory requirements is the obligation for registrants to address conflicts of interest in the best interest of the client.

Compliance with the conflict of interest requirements is an ongoing registrant obligation, not a one-time determination. You and your registered firm are required to take reasonable steps to identify both existing conflicts of interest and those conflicts of interest that are reasonably foreseeable.

Definition of Conflict

In general, a conflict of interest is a situation where there is a divergence between the interests of two or more parties.

Under Companion Policy (CP) 31-103, Part 13, Division 2, s. 13.4.1, the Canadian Securities Administrators (CSA) specifically define a conflict of interest to include any circumstance where:

- the interests of a client and those of a registrant are inconsistent or divergent
- a registrant may be influenced to put their interests ahead of their client's interests
- the trust that a reasonable client has in their registrant may be compromised as a result of:

- monetary or non-monetary benefits available to the registrant
- potential detriments that the registrant may be subject to

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As specified in the policy, you and your dealer are required to determine whether a conflict is material. When determining whether a conflict is material, you should consider whether the conflict may be reasonably expected to affect:

- the decisions of the client
- the recommendations or decisions you make

Conflicts of Interest between Registrants and Clients

The requirements governing conflicts of interest between registrants and clients have been developed under the *Client Focused Reforms* (CFR) and brought into force under NI 31-103 and the CIRO Rules. Under the reforms, you must take reasonable steps to:

- identify existing and reasonably foreseeable material conflicts of interest
- address all material conflicts of interest in the best interest of the client

You, as a Dealing Representative, have specific responsibilities under the CFR requirements, as summarized below.

Your Responsibilities for Conflicts of Interest
You are responsible for: • taking reasonable steps to identify existing and reasonably foreseeable material conflicts of interest • promptly reporting material conflicts of interest to your firm • addressing material conflicts of interest in the best interest of the client • avoiding all material conflicts of interest where the conflict cannot be addressed in the best interest of the client You are prohibited from engaging in trading and/or advising activities unless: • the conflict has been addressed in the best interest of the client; and • your firm has approved the activity.

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Identifying Conflicts of Interest

Conflicts of interest will arise in the ordinary course of business. Some conflicts are inherent to the firm's business model. Other conflicts may arise from the business activities you carry out.

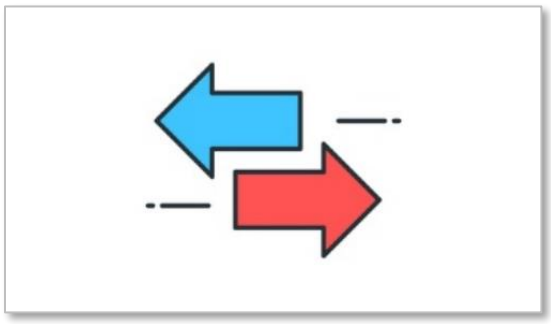
Conflicts of interest may take various forms such as:

- existing - involving an actual conflict as a result of current activities
- potential - involving likely future conflicts
- perceived - involving circumstances creating the appearance of a conflict

By their very nature, conflicts can interfere with your ability to deal fairly, honestly, and in good faith with clients. It is simply good business to know how conflicts arise and understand the duty to identify and address them.

You are required to take reasonable steps to identify existing and reasonably foreseeable material conflicts of interest.

As established in CP 31-103, reasonable steps to identify material conflicts of interest would include:



- taking proactive measures to anticipate reasonably foreseeable conflicts
- implementing policies and procedures to identify existing conflicts
- assessing the materiality of those conflicts to distinguish between those conflicts that are material and those that are not

The duty to identify and address conflicts of interest is not viewed as a one-time exercise and compliance with the conflict of interest requirements is an ongoing obligation. Therefore, you are expected to assess and address new conflicts as they are identified.

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Addressing Conflicts of Interest

A conflict of interest can be addressed in one of three ways:

- avoidance
- control
- disclosure

Where a conflict of interest between you and your client is identified, you are subject to specific regulatory obligations. Where the conflict is deemed to be material, you must:

- address all material conflicts of interest in the best interest of the client
- avoid all material conflicts of interest where the conflict cannot be addressed in the best interest of the client

When addressing a ***material*** conflict of interest, you and your dealer are required to either:

- implement controls to mitigate the conflict sufficiently so that the conflict is addressed in the client's best interest; or
- avoid the conflict.

Your failure to identify and properly address a conflict could put you and your firm at risk of disciplinary action by the regulators or civil action by a client. Therefore, it is important that you understand and commit to the notion that you must address all material conflicts of interest in the best interest of the client and avoid those material conflicts of interest that cannot be addressed in the best interest of the client.

Avoidance

You are required to avoid all conflicts of interest that are prohibited by law. Examples of conflicts of interest that must be avoided include those practices prohibited under securities legislation and regulations, or other activity that is sufficiently contrary to the integrity of the capital market and/or the interests of investor(s).

Even where a conflict of interest is not legally prohibited, it must be avoided if there can be no other reasonable response.

Under CP 31-103, Part 13, Division 2, s. 13.4.1, you would be expected to avoid material conflicts of interest:

- where there are no appropriate controls available that would address the conflict in the best interest of the client
- where avoiding the conflict is the only reasonable response in order to address the conflict in the best interest of the client

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- even if avoiding the conflict means foregoing an otherwise attractive business opportunity or type of compensation

Where you determine that a material conflict of interest should be avoided, you may do so by:

- refusing to engage in the activity
- ceasing to provide the product or service
- declining to deal with the client

Control

The purpose of disclosing a conflict of interest is to provide the client with adequate information so that they can decide for themselves whether the conflict is serious enough to lead them to withdraw from the transaction or service. Firms are required to provide written disclosure to clients to disclose all material conflicts of interest identified and reported to the firm. Where required, you may likely be responsible for providing disclosures prescribed by the firm.

When determining how to address material conflicts of interest, your firm must consider what internal structures or policies and procedures can be implemented in order to address the conflict of interest in the best interest of the client.

Conflicts Arising from Compensation and Incentives

It is important to note that the regulators assign a great deal of importance to conflicts arising from compensation and incentives. As such, you should focus specific attention to your firm's policies and procedures governing conflicts that arise from compensation and incentives to ensure that:

- you adhere to the firm's requirements
- conflicts of interest are addressed in the best interests of clients

Conflicts arising from internal compensation arrangements and incentive practices
As stated in CP 31-103, s. 13.4.1: "It is an inherent conflict of interest for registered firms to create incentives to sell or recommend certain products or services over others. It is also an inherent conflict of interest for registered individuals to receive greater compensation from their sponsoring firm for the sale or recommendation of certain products or services over others. In our experience these are almost always material conflicts of interest."

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The CP goes on to state:

"In addition to controlling these conflicts in the best interest of clients, registrants must comply with the suitability determination obligation under section 13.3. If certain products or services available at a firm compensate its registered individuals better than others, in addition to determining that the recommendation is suitable, registered individuals must put their clients' interest first when deciding which product or service to recommend. As a result, the client's interests, not the registrant's interests, must guide the recommendations made by a registrant to its clients. Registrants must not recommend a product or service just because it pays them better than the alternatives. This is also consistent with a registrant's obligation to deal fairly, honestly and in good faith with its clients."

Disclosure

The purpose of disclosing a conflict of interest is to provide the client with adequate information so that they can decide for themselves whether the conflict is serious enough to lead them to withdraw from the transaction or service. Firms are required to provide written disclosure to clients to disclose all material conflicts of interest identified and reported to the firm. Where required, you may likely be responsible for providing disclosures prescribed by the firm.

Disclosure about conflicts of interest must be:

- prominent, specific, clear, and meaningful to the client, so that they can understand the conflict of interest and how it could affect the product or service that is being offered

- made prior to or at the time of the investment recommendation or service, so the client has time to assess the information

Written disclosure of material conflicts of interest must include:

- the nature and extent of the conflict
- the potential impact and risk the conflict may pose
- how the conflict has/will be addressed

Where a material conflict of interest is identified that has not been previously disclosed to the client, the firm is responsible for providing disclosure to the client in a timely manner. In some cases, you will be required to provide disclosure to the client when these circumstances arise.

While disclosure can be effective in addressing certain conflicts of interest, disclosure alone is not considered sufficient to address a material conflict of interest between a registrant and a client. Disclosure is meant to supplement other measures and controls taken to address the conflicts.

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Example

Jonas has a client, Adrian, who bought and then sold the PanCanada Fund, a return of capital investment fund. Adrian needs help filing her T1 Return because she has never calculated her adjusted cost base on a return of capital fund before. Luckily, Jonas has an ownership interest in Pro-Tax Services Ltd., a tax preparation firm. Before Jonas can refer Adrian to Pro-Tax Services he must:

- obtain approval from his dealer for his outside activity, Pro-Tax Services Ltd.
- obtain approval from his dealer for the written disclosure for Pro-Tax Services Ltd., which must clearly disclose Jonas' conflicts of interest (e.g. Jonas will profit from his interest in Pro-Tax when Adrian uses the service)
- provide the written disclosure for Pro-Tax Services Ltd. to his client, Adrian, *before* he refers her to Pro-Tax

Disclosure of Compensation Conflicts

As set out in CP 31-103, s. 13.4.1, you are expected to disclose to your clients any commissions or other compensation that you will receive for a transaction ***before*** the transaction is executed. The CP also explicitly states:

"If a representative's compensation differs depending on the products or services provided, then this is a material conflict that must be disclosed to clients. With respect to the nature and extent of the conflict, the registrant should disclose a summary of the compensation conflict in plain language. For example, if particular products pay a larger percentage-commission than other products available to the client, the extent of the compensation difference should be explained."

Limitations of Disclosure

In some cases, disclosure can play an effective part in addressing conflicts of interest. However, disclosure alone would not be considered sufficient to address a material conflict of interest. For example, compensation and transaction charges are disclosed in the Relationship Disclosure Information (RDI) that is provided to clients when they open an account and in the pre-trade disclosure before an order is executed. However, there is an added expectation that there is adequate supervision by the firm to ensure that the fees are competitive, reasonable, and appropriate for clients.

There are also circumstances where disclosure would be clearly insufficient to address a conflict of interest. In such cases, you would need to avoid the conflict of interest. For example, disclosure may not be used to justify an unsuitable recommendation.

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Example

As established in the guidance provided under MFDA Staff Notice MSN - 0069, *Know-Your-Client (KYC) and Suitability*, disclosure cannot negate the obligations of registrants under regulatory requirements. As stated in the notice:

"The obligation to make a suitability determination is a fundamental obligation owed by Members and Approved Persons to their clients and is critical to ensuring investor protection. It is a cornerstone of the registration regime and an extension of the duty to deal fairly, honestly and in good faith which Members and Approved Persons owe to their clients. It cannot be satisfied through the provision of disclosure or by obtaining a client waiver."

Once a conflict of interest has been identified and addressed, you must document the reasonable basis for your determination that the conflict of interest has been addressed in the best interests of the client(s). As the materiality of a conflict increases, there should be greater detail in the records maintained to demonstrate compliance. For example, the regulators would expect to see more detailed records for material conflicts related to sales practices, compensation arrangements, incentive practices, referral arrangements, and the use of proprietary products and services.

Bottom Line

You need to be mindful of any conflicts of interest, be very familiar with your obligations under Mutual Fund Dealer Rule 2.1.4, and follow your dealer's policies and procedures for managing conflicts. You must position your practice to minimize, recognize, and manage conflicts and keep records of any conflicts that have arisen and how they were resolved.

Common Conflicts of Interest

As is inherent with any compensation-based industry, it is not uncommon for conflicts of interest to arise through the normal course of business conducted by you and your dealer. The important thing to do is to properly identify and address conflicts of interest that arise. Summarized below are some of the common conflicts of interest that can be expected to emerge at registered firms.

Common Conflicts of Interest*	
Type/Activity	**Potential Conflicts of Interest can Arise From:**
Proprietary Products such as: • deposit products • structured products • investment funds	• conflicts that stem from the competing interests of the firm, wanting the proprietary products to be successfully distributed, and clients' needs to be suitably invested in appropriate investment products

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Common Conflicts of Interest*	
Type/Activity	**Potential Conflicts of Interest can Arise From:**
Compensation-Related Conflicts	• conflicts stem from the compensation structure of a given product which may motivate the sale of that product, for example: - trailing commissions/fees - deferred sales charge (DSC) commissions - syndication fees - performance fees - managed account/fee-for-service fees - embedded fees • the product offers a higher commission rate or an ongoing stream of income over time while other products offer lower or finite commission potential
Referral Arrangements and Service Arrangements	• referral fees, trailer fees, split commissions • other fees (e.g. syndication fees) • other benefits
Dual Occupations and Outside Activities	• compensation from the dual occupation/outside activity • position of influence gained from the dual occupation/outside activity that could impact the relationship with clients
Gifts, Gratuities, and Non-Monetary Benefits	• gifts, gratuities, and non-monetary benefits received from clients
* *This is not meant to be an exhaustive list of all conflicts of interest. Other conflicts of interest may arise that are not included on this list, but would be material and would require that the registered firm and Dealing Representative address the conflict of interest in the best interest of the client.*	

When making a determination of how the firm will address a conflict of interest, the steps that the dealer must take to address the conflict of interest will most often be established in the legislation, regulations, and guidance from the securities regulators. It is your responsibility to follow your firm's policies and procedures, and any decisions the firm makes, to address conflicts of interest.

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Lesson 4: Compliance Issues and Prohibited Practices

Introduction

In your role as a Dealing Representative, you will face a number of compliance issues relating to your job duties and your dealings with clients. For the most part, your mutual fund dealer will have policies and procedures in place to guide you.

This lesson provides information about common compliance issues and prohibited practices.

This lesson takes approximately 45 minutes to complete.

At the end of this lesson, you will be able to:

- explain compliance issues that may commonly arise including:
    - personal financial dealings with clients and control or authority over client accounts
    - benefits to or from clients
    - dual occupations and outside activities
    - dual licensing
    - referral arrangements
    - sales communications
    - trade names and business titles
- explain prohibited practices including:
    - prohibited practices concerning trade authorization
    - prohibited trading practices
    - prohibited practices concerning personal financial dealings

NOTE: If you are ever unsure about how to deal with a given situation, check with your firm’s Compliance Department.

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Common Compliance Issues

In your role as a Dealing Representative, compliance issues can arise during the normal course of business. It is important that you are aware of these issues and the expectations when they arise.

Compliance issues that commonly arise include:

- personal financial dealings with clients
- control or authority over a client's account or financial affairs
- benefits to or from clients
- dual occupations and outside activities
- dual licensing as a life insurance agent
- referral arrangements
- sales communications
- trade names and business titles

Personal Financial Dealings and Control or Authority over Client Accounts

Personal financial dealings with clients or having control or authority over a client account will often create a conflict of interest that can potentially impair your ability to fulfill your obligations to your clients. You must be aware of the restrictions and limitations imposed by the regulators and strictly follow your firm's policies and procedures related to personal financial dealings with clients and control or authority over client accounts.

Personal Financial Dealings with Clients & Control or Authority over Client Accounts	
Complete or Partial Control or Authority over a Client Account	• acting under a Power of Attorney (POA), as trustee, as executor, or under any other similar authorization, or otherwise having full or partial control or authority over the client's account or financial affairs • under Mutual Fund Dealer Rule 2.3.1, you are prohibited from having authority over client accounts such as POA, trustee, etc. • you are required to disclose your authority over any account to your firm • the firm is required to re-assign the account to another Dealing Representative who does not have authority

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Personal Financial Dealings with Clients & Control or Authority over Client Accounts	
Lending to Clients	• lending to clients is not permitted *(Limited exceptions for advancing funds for redemptions may be permitted if permitted by your firm. You must follow your firm's policies and procedures.)*
Borrowing from Clients	• borrowing from clients is not permitted *(You must follow your firm's policies and procedures for exceptions, where your firm allows such exceptions)*
Purchasing Assets from a Client	• purchasing an asset from a client outside the normal course of business (e.g. real property or other assets of significant value) • would represent a material conflict of interest that should be avoided *(You must follow your firm's policies and procedures for exceptions, where your firm allows such exceptions)*
Private Investment Schemes	• private investment schemes include: - investment clubs where you and your clients invest together - co-investment by you and your clients in pyramid-like schemes or other questionable investments • these arrangements are prohibited • securities-related business outside of the firm is a breach of regulations

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Personal Financial Dealings with Clients & Control or Authority over Client Accounts	
Positions of Influence in the Community	• you occupy a leadership role in the community (e.g. pastor at a local church, nurse at a nursing home) • you must disclose your role to your firm • the regulator will usually impose terms and conditions on you to restrict you from dealing with clients related to your role (e.g. restrict you from dealing with members of the church, patients of the nursing home, etc.) • at minimum, the firm must implement procedures to protect clients from undue influence

Power of Attorney

A power of attorney (POA) is a legal document that allows a person to act on another person's behalf. There are two kinds of POA:

- limited POA
- general POA

A limited POA restricts permitted actions to those of a specific nature, such as financial matters, whereas a general POA permits a broader range of activities. You should be fully aware of your firm's policies and procedures for accounts which have appointed a POA for the account.

Benefits To or From Clients

Non-monetary benefits such as gifts or charitable donations are sometimes used as compensation for inappropriate activities carried on by Dealing Representatives. When used inappropriately, they are used in exchange for referrals or as a means of private settlement where Mutual Fund Dealer regulations may have been breached.

You are required to ensure that all such benefits of a material amount flow through your mutual fund dealer. You must obtain your mutual fund dealer's approval prior to carrying out any such arrangement since the firm is responsible for ensuring that:

- any conflicts of interest are addressed in the best interests of clients
- activity is properly monitored

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In general, benefits of nominal value are not normally seen as a conflict of interest. Regardless, you are required to strictly follow your firm's procedures for monetary and non-monetary benefits to or from your clients.

Example

Larry, a Dealing Representative with ABC Financial, has a condo in Florida. One of his high-net-worth clients was planning a month-long family holiday in Florida. Larry gave his client the keys to his Florida condo and invited him to stay there at no charge for the duration of the client's month-long stay. Larry did not see the need to inform his mutual fund dealer, since he owns the condo and he is free to let anyone use it. Larry has violated the Mutual Fund Dealer Rules pertaining to monetary or non-monetary benefits from or to clients because the rental cost of the condo for a month is clearly of material value.

Dual Occupations and Outside Activities

Dual occupations and outside activities are permitted under securities legislation and regulations where prescribed conditions are satisfied. Dual occupations are business activities that are not carried out on behalf of the firm and involve the payment of compensation. Generally speaking, dual occupations are those business activities that do not fall under your role with your firm, for example: insurance, mortgage brokerage, real estate, tax preparation, etc.

Outside activities include dual occupations, and also include activities that are not dual occupations (with or without compensation). Outside activities must be declared whether or not compensation or remuneration is paid for the activity, for example:

- acting as a board member, officer, director, or equivalent (whether or not remuneration or other benefit is received for the position)
- acting as a member of a charitable organization
- acting as a volunteer in the community
- holding a position of influence, such as:
  - religious leaders
  - health care providers
  - military officers
  - any other positions of influence

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As can be reasonably expected, there is a potential for conflicts of interest to arise when you engage in outside activities. For example, conflicts of interest can result from:

- compensation from the activity
- the nature of your relationship with the outside entity and/or any members of the outside entity
- conflicting duties of your role with your dealer and your role with the outside entity
- possible knowledge of insider information
- conflicting demands on your time

Obtain Your Dealer's Authorization

Mutual Fund Dealer Rule 1.3.2 requires you to obtain your dealer's approval before engaging in an outside activity. You are required to obtain your dealer's approval for outside activities:

- upon registration application: *Form 33-109F4 Registration of Individuals and Review of Permitted Individuals*
- before you commence new outside activities during the term of your registration: *Form 33-109F5 Change of Registration Information*

You must also notify your dealer if there are material changes in an outside activity that has previously been approved.

Review and Approval of Outside Activities

Firms that allow their Dealing Representatives to engage in outside activities (OAs) must have a review process in place. Your dealer is responsible for:

- reviewing and approving outside activities disclosed to the firm
- ensuring that outside activities, and associated trade names where applicable, are reported to the securities regulators
- ensuring that outside activities, and any associated conflicts of interest, are properly addressed in the best interest of the client(s) and are disclosed to clients
- having supervisory controls in place in order to detect undisclosed outside activities

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Depending on your firm's policies and procedures, your outside activity may be approved provided that:

- you are permitted, under legislation, to devote less than your full time to the business of the dealer
- the activity is not prohibited by the securities regulator in the jurisdiction
- conflicts of interest are identified and addressed in the best interest of the client(s)
- the activity does not bring the Canadian Investment Regulatory Organization (CIRO), its members, or the investment fund industry into disrepute
- proper disclosure is provided to clients to:
    - clearly communicate that the outside activity is not the business of the dealer and is not the responsibility of the dealer
    - disclose any conflicts of interest

For instance, your dealer may permit an outside activity involving the sale of deposit instruments, such as Guaranteed Investment Certificates (GICs), through an entity other than your mutual fund dealer.

Inappropriate Outside Activities

An outside activity carries the potential for conflicts of interest. Before approving any outside activities, a mutual fund dealer is required to consider conflict of interests including the compensation to be paid under the arrangement, the nature of the relationship between the Dealing Representative and the outside entity, and any other potential conflicts that are identified. If a conflict cannot be addressed in the best interest of the client(s), the outside activity will not be permitted by your mutual fund dealer.

Undisclosed outside activities are strictly prohibited including, but not limited to, those involving the sale of investment products outside of the mutual fund dealer such as:

- principal-protected notes
- referral arrangements where compensation is paid for the referral
- limited partnership units
- private placements
- other exempt market securities

You must not engage in any outside activities without obtaining written approval from your mutual fund dealer.

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Bottom Line

Remember that you must seek approval from your dealer before engaging in any outside activities and you must also disclose all outside activities to the securities regulators:

- when you first become registered
- before you commence new outside activities during the term of your registration

Your dealer has the authority to decline approval for any outside activity which they determine not acceptable. If your dealer declines an outside activity, you are not permitted to engage in that outside activity under any circumstances. Dealing Representatives that engage in outside activities that have not been approved by their dealers can be subject to disciplinary action by the dealer, CIRO, or both.

Dual Licensing as a Life Insurance Agent

All provinces have regulations that permit individuals to be both licensed life insurance agents and registered Dealing Representatives. While mutual fund dealers do not have specific obligations under the Mutual Fund Dealer Rules to supervise the activity conducted under a dual occupation/outside activity, including life insurance, they are expected to have certain measures in place to:

- review dual occupations/outside activities for approval
- ensure that there is no change in dual occupations/outside activities that were approved
- ensure that the distinction between the dealer's business and dual occupation/outside activity is properly disclosed
- monitor for conflicts of interest
- follow up on any client complaints that relate to dual occupations/outside activities

In cases where the dealer needs to investigate conflicts of interest or complaints concerning a dual occupation/outside activity, you will be expected to grant access to any files or records necessary to allow the dealer to complete their investigation.

Referral Arrangements

Referral arrangements are arrangements where a Dealing Representative agrees to provide or receive a referral fee for the referral of a client. A referral fee is any form of benefit or compensation, direct or indirect, for the referral of a client and includes the splitting of a commission or fee from a transaction. Referral arrangements can involve securities-related business and non-securities-related business.

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Securities-Related Business	• between registrants; or • compensation is paid for the referral ➢ The activity must be conducted through your dealer and disclosed to the client, regardless of registration status of the other referral party.
Non-Securities-Related Business	• involving non-registrants; and • compensation is NOT paid for the referral

Conflicts of interest can be expected to arise from referral arrangements due to the financial interests that emerge from receiving referral fees, splitting commissions, and other forms of compensation and benefits. It is also critically important to ensure that clear disclosure about the roles and responsibilities of all parties are provided to clients.

For a referral arrangement to be permitted under securities regulations, certain conditions must be satisfied. As established in Section 13 of NI 31-103 and Mutual Fund Dealer Rule 2.4.2, the following provisions apply with respect to referral arrangements:

Referral Arrangements

- there must be a written referral agreement in place before any referrals take place
- the registered firm(s) must be a party to the referral agreement
- all referral fees must be recorded on the books and records of the registered firm(s)
- written disclosure of the referral, in prescribed form, must be provided to clients before accounts are opened or services are provided to clients
- the registered firm must satisfy itself that the person/company that is accepting the referrals has the appropriate qualifications and/or registration to provide the services before any referrals take place
- the “Know Your Product” obligations apply to referral arrangements and registered firms are required to conduct due diligence to determine whether referral arrangements should be approved by the firm

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Even if you directly negotiate a referral arrangement with another party, your dealer must be a party to the referral agreement, which means they must ultimately approve the arrangement and ensure that compensation flows through their books and records. This is because the dealer is obligated to supervise and monitor your activities under referral arrangements.

Although referral arrangements are a widely used and permissible practice in the industry, they require the active involvement of the mutual fund dealer. You are not permitted to enter into referral arrangements or receive referral fees of any nature "outside" of your dealer. Such practices constitute undisclosed outside activities that are not compliant and can result in disciplinary actions against you by your firm, CIRO, or both.

Referral Arrangements with other Registered Firms

When a referral arrangement involves another registered firm, such as an investment dealer, portfolio manager, or exempt market dealer, there are limitations on the activities that you may conduct. You are not permitted to carry out any of the following activities:

- completing new account opening documents or Know Your Client (KYC) information for the other registered firm
- participating in meetings where clients are given investment advice with respect to the accounts at the other registered firm
- accessing clients' account information and/or trading activities from the other registered firm

As set out in MFDA Staff Notice MSN-0071, a Dealing Representative who engages in activities such as those above, or otherwise acts as the relationship manager for a client of the other registrant, is in breach of Mutual Fund Dealer Rule 1.1.1 (a), to conduct all securities-related business through their dealer. Even where the other registered firm is an affiliate firm of your dealer, you are not permitted to engage in those activities which are restricted.

Example

John has an arrangement with Thomas where John refers clients to Thomas to invest in stocks. Thomas is an Investment Representative with an investment dealer. There is a written referral agreement, John obtained prior approval from his dealer's Compliance Department, and the referral fees flow through his dealer.

However, John is strictly prohibited from advising on or recommending any specific stocks to his clients. This can only be done by Thomas. John cannot act beyond the limits of his registration through a referral arrangement.

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Conflicts related to Referral Arrangements

It is important to note that the regulators assign a great deal of importance to conflicts arising from referral arrangements.

Conflicts related to referral arrangements

As stated in CP 31-103, s. 13.4.1:

"Paid referral arrangements are inherent conflicts of interest which, in our experience, are almost always material conflicts of interest, and must be addressed in the best interest of the client. Before a registrant refers a client, in exchange for a referral fee, to another party, the registrant must determine that making the referral is in the client's best interest. In making that determination, we expect registrants to consider the benefits to the client of making the particular referral over alternatives or at all.

In making a referral, registered firms and individuals must be guided only by the client's interests. We therefore expect that a registrant will not make a client referral to a party solely because of the referral fee that they will receive from that party, or because the amount or duration of the referral fee that they will receive from that party may be greater than the amount or duration of the referral fee that they would receive from a competitor to that party. If a client pays more for the same, or substantially similar, products or services as a result of a referral arrangement, we would not consider the inherent conflict of interest to have been addressed in the best interest of the client. This is also consistent with a registrant's obligation to deal fairly, honestly and in good faith with its clients."

Vigilant effort is required to ensure that conflicts of interest related to referral arrangements are properly addressed, requirements are followed, and proper disclosure is provided.

Sales Communications and Advertisements

As a Dealing Representative, you will likely want to communicate with your clients by phone, email, letter, newsletter, website, social media, and other means. There are strict rules governing what you can say in your communications to clients, including those you make verbally or in writing.

Sales communications include any communication relating to an investment product that induces the public to invest, including those about investment funds.

Advertisements are sales communications that are published through a public medium including:

- video and audio recordings
- infomercials
- displays
- billboards

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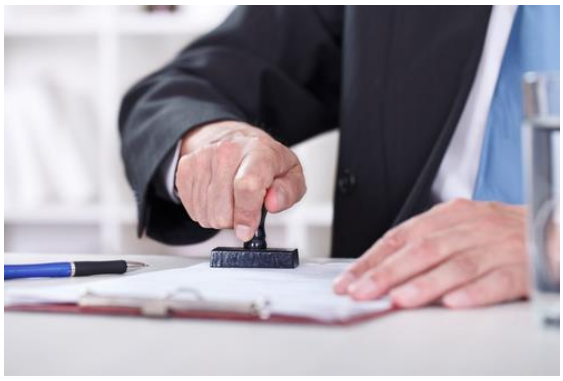
- newspaper and magazine advertisements
- radio, television, and website advertisements

Sales communications do not include the disclosure documents that must be delivered to investors including prospectuses, *Fund Facts*, financial statements, or mandatory reports including trade confirmations and client account statements.

Pre-Approval by Your Dealer

All advertising and sales communications, including websites, must be approved by your dealer before you can publish or issue the communication. Be sure to consult your dealer's policies and procedures on advertisements and sales communications and submit your marketing materials to the designated person for pre-approval.

Your dealer will designate a partner, director, officer, compliance officer, or branch manager to review and approve advertising and sales communications.



Sales Communication Dos and Don'ts

For mutual fund dealers and their Dealing Representatives, Mutual Fund Dealer Rule 2.7.2 sets the standards for advertisements and sales communications. The purpose of the rule is to prohibit misleading marketing materials. Below are some examples of what you can and cannot do in your advertising and sales communications.

What You Can Do

As long as you follow the rules, you are permitted to:

- provide information on a fund's features and attributes
- make certain comparisons between funds
- promote the absence of fees and charges for a fund
- discuss the investment performance of a fund, including ratings and rankings
- provide quotations, rates of return, yield, volatility, or any other measurement of performance

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What You Cannot Do

The overriding principle for a sales communication is that it must not be misleading. As a result, you cannot:

- make an untrue statement or any statement that is false or misleading
- omit a material fact that, if excluded, would make the sales communication misleading
- include an unjustified promise or a guarantee of specific results
- include a visual image that gives a misleading impression, such as a photograph, sketch, drawing, illustration, logo, or graph
- use unrepresentative statistics to suggest unwarranted or exaggerated conclusions, or fail to identify the material assumptions made to arrive at the conclusions
- provide an opinion or forecast of future events that is not clearly labeled as such
- fail to fairly present the potential risks to the client
- make any statements that are detrimental to the interests of the public or the industry
- contravene any applicable legislation or regulation

Example

Tony sends out emails to a few of his high-net-worth clients informing them about a new investment fund that has just been launched. He states that he is very confident that the fund will reward its investors with a guaranteed return of 7%.

Sending out a sales communication that states that an investment fund has a guaranteed return is a violation of Mutual Fund Dealer Rule 2.7.

Example

Tony has sent out the above emails without getting it pre-approved by his designated Branch Manager. He has committed another regulatory breach under the Mutual Fund Dealer Rules and he will likely be disciplined for doing so.

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Trade Names and Business Titles

Operating under a trade name is a common practice for Dealing Representatives. You are permitted to conduct business under a trade name as long as the following conditions are met:

- your dealer has given its prior written consent to use the trade name
- your dealer has notified CIRO of the trade name
- the trade name is used together with the legal name of the dealer and the dealer's legal name is at least equal in size and prominence to the trade name
- the trade name is not misleading in any way

Mutual Fund Dealer Rule 1.1.7 establishes the requirements for the use of trade names and business titles for mutual fund dealers and their Dealing Representatives. Further guidelines are encompassed in MFDA Staff Notice MSN-0032. You are not permitted to operate under any trade name or business title unless it is first approved by your dealer in writing.

All Dealing Representatives are governed by the "holding out rule", Mutual Fund Dealer Rule 1.2.5. This rule prohibits you from "holding yourself out" to the public in any manner which could reasonably be expected to deceive or mislead a client or other person about your:

- proficiency
- experience
- qualifications
- registration category
- nature of your relationship with the firm/individual
- products and/or services to be provided

The rules establish that you are restricted from using any titles or designations which are:

- based partly or entirely on your sales activity or revenue generation
- a corporate officer title (e.g. Vice President, Director), unless you have been appointed to the office under applicable corporate law
- not approved by the firm

You should be fully versed in your firm's policies and procedures for business titles and learn which business titles and designations you may use, how they may be used, and those business titles and designations which would be restricted or prohibited.

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Business cards and other stationary items, such as letterhead, fax cover sheets, and email auto signatures are all subject to the "holding out rule". As such, all stationary materials must be pre-approved by your dealer in the same way as sales communications and advertisements.

Example: Holding Out Rule

Christopher Smith works as a Dealing Representative with ABC Investments Inc. Christopher is also a Chartered Professional Accountant (CPA). Christopher has business cards printed with the following information:

ABC Investments Inc.

Christopher Smith
Chartered Professional Accountant
543 Finance Street, Suite #100
Capital City, Alberta, A1B 2C3
403-555-1212
csmith@abcinvest.ca

Example: Holding Out Rule

In the example above, Christopher is holding out a legitimate designation to the public in a misleading manner. Although he is qualified as a Chartered Professional Accountant, he is not employed by ABC Investments in that capacity. Instead, Christopher is permitted to add the "CPA" designation after his name, like this:

ABC Investments Inc.

Christopher Smith, CPA
Dealing Representative
543 Finance Street, Suite #100
Capital City, Alberta, A1B 2C3
403-555-1212
csmith@abcinvest.ca

It is important to note that the regulators assign a great deal of importance to the use of business titles that convey expertise in seniors' issues or retirement planning. You must be fully qualified in order to use any such designations.

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Acceptable designations would be those that:

- have a rigorous curriculum and examination process
- have experience requirements
- are issued by reputable organizations

Prohibited Practices

There are certain practices that are prohibited under securities legislation and regulations. The prohibited practices specific to the Dealing Representatives of mutual dealers are largely set out in the Mutual Fund Dealer Rules (MFD Rules) of CIRO. The prohibited practices under CIRO can be split into the categories below.

Prohibited Practices	
Prohibited Practices concerning Trade Authorization	• Partial or full control or authority including power of attorney, trustee, or executor • Signature falsification • Pre-signed forms • Discretionary trading
Prohibited Trading Practices	• Unregistered trading • Stealth advising • Excessive trading and churning
Prohibited Practices concerning Personal Financial Dealings	• Personal financial dealings

You are prohibited from engaging in these prohibited practices. Individuals who engage in prohibited practices risk investigation, prosecution, suspension, termination, and litigation.

Restrictions from having Control or Authority

Under Mutual Fund Dealer Rule 2.3.1, you are strictly prohibited from having partial or full control or authority over the financial affairs of a client including appointment as a:

- power of attorney
- trustee
- executor
- any other similar authorization

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Subject to certain conditions, there is a limited exception which allows you to accept an appointment to have control or authority provided that all of the following conditions are met:

- the client is directly related to you, as defined under the Income Tax Act (i.e. spouse, parent, or child)
- you notify your dealer of the appointment
- you obtain written approval from your dealer prior to accepting or acting upon the control or authority

For these special cases only, you may be allowed to accept an appointment to have control or authority. However, you must follow your dealer's policies and procedures and certain conditions will apply.

It is very important to remember that the exception above cannot be extended to other clients or other family members. Accepting or acting as a control or authority over the financial affairs of any other family member, client, or account is strictly prohibited.

Example

Derek has received an overseas assignment and wants his brother Justin, who is a Dealing Representative, to take care of his investments while he is away. Justin is registered at the dealer where Dered holds his accounts.

Derek gives a general power of attorney to Justin giving him full authority to manage his financial affairs. Although Derek is Justin's family, the exception permitted under the Mutual Fund Dealer Rules applies to immediate family only – spouse, children and parents.

Justin cannot accept the POA.

Signature Falsification

A Dealing Representative who falsifies the signature of their client is clearly in violation of their duty to deal fairly, honestly, and in good faith with their clients. Such conduct brings into question the Dealing Representative's intentions and their integrity as a registrant under securities regulation.

Summarized in the table below are cases which the regulators consider signature falsification.

Signature Falsification
• Having a client sign a form which is blank or only partially completed (a pre-signed form). • Signing a client's name to a document. • Cutting and pasting a signature from one form to another.

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Signature Falsification

- Altering information on a signed document without the client initialling the document to show that the change was approved.
- Reproducing client initials beside changes made to a document where the client forgot to initial.
- Having a client sign multiple forms for use in future trading.
- Using correction fluid or tape to white out old instructions on a signed client form and write in new instructions.
- Receiving client instructions over the phone or by e-mail and signing the client's signature on an account form to carry out the instructions.
- Photocopying a previously submitted account form and altering the trade details in order to process a new trade.

The regulators consider signature falsification a serious infraction which falls well below the ethics and conduct expected of registrants in the securities industry. The regulators' focus on cases of signature falsification stems from the fact that the practice is often an indicator of fraud, misappropriation, or unauthorized trading.

You are strictly prohibited from falsifying the signature of any client for any reason.

Pre-Signed Forms

All applications, forms, trade tickets, trade instructions, and any other documents which require your clients' signature must be signed by the client ***after*** the documents have been duly completed. The MFD Rules prohibit Dealing Representatives and mutual fund dealers from using blank forms that have been pre-signed by their clients, known as pre-signed forms.

You are strictly prohibited from obtaining, accepting, or retaining any blank, pre-signed forms for your clients. The mere presence of pre-signed forms will be reported to the CIRO Enforcement Department.

Discretionary Trading

Unlike mutual fund dealers, firms under the registration category of portfolio manager and investment dealer may offer "discretionary" accounts. Discretionary accounts are a special kind of client account where the client signs a *Discretionary Agreement* which gives the investment advisor trading authority over the account. Mutual fund dealers and their Dealing Representatives are prohibited from discretionary trading.

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You are prohibited from executing trades in your clients' accounts unless you have express authorization from the client for each and every trade before it is entered. Before you proceed with any trade, you are expected to discuss the proposed trade with the client and obtain their full agreement to the trade prior.

If you operate your practice in client name, the client accounts are held at the fund company and are registered the clients' names. For client-name accounts, you will need to obtain your client's signature on the actual trade ticket/instructions for redemptions or for accounts without a Limited Authorization Form (LAF).

In order to facilitate more efficient trading where client signature is not required, dealers are permitted to accept Limited Authorization Forms (LAFs) from clients. By signing the prescribed LAF, the client authorizes the fund company to accept trades from their dealer without the client's physical signature for each trade.

Mutual Fund Dealer Rule 2.3.2 imposes the following conditions for the use of LAFs:

- the prescribed LAF must be used
- the LAF must be approved by a Compliance Officer or Branch Manager
- the LAF must be retained in the client's file

It is important to note the following restrictions for the use of LAFs:

- LAFs may not be accepted by the fund companies for certain redemptions or withdrawals from registered plans
- a LAF does NOT confer discretionary trading authority

Where there is a LAF for an account or where the account is held in nominee name, you must still maintain evidence of client authorization for each and every trade. You may only initiate a trade following specific authorization from the client, for example, by telephone, fax, or other electronic means.

Example

Mrs. Earnshaw is a client of ABC Financial Services, a mutual fund dealer. She owns several investment funds which are held in her own name at the investment fund company.

Her Dealing Representative is concerned about the difficulty of obtaining her signature to carry out trades while she is up north. A LAF may be appropriate in these circumstances. The LAF would enable trades to be executed without the fund company having to receive signed instructions from Mrs. Earnshaw in every case. Before placing a trade, the Dealing Representative would still need to contact the client, obtain her authorization, and record the full details of the client's authorization including the client's name, account number, date, time, substance of her instructions, etc.

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You are strictly prohibited from executing any trade under an LAF when you do not have the client's prior authorization for the trade. A LAF does not, under any circumstances, give you discretionary authority.

Unregistered Trading

Unregistered trading is where an individual conducts trades in securities and they are NOT:

- registered in the jurisdiction (i.e. province or territory); and/or
- registered under the appropriate registration category.

You are strictly prohibited from unregistered trading. Unregistered trading is a violation of the *Securities Act* in every jurisdiction of Canada.

Stealth Advising

Stealth advising refers to a practice where a registered individual allows another "unregistered" individual to conduct securities-related business using their Dealing Representative code. In doing so, the registered individual is complicit in unregistered trading and is in violation of the *Securities Act* for the applicable jurisdiction.

You are strictly prohibited from engaging in stealth advising and from being a party to any arrangement which is complicit in unregistered trading.

Excessive Trading

Investing in mutual funds is typically geared towards a long term buy-and-hold strategy. As such, a pattern of frequent trading would be uncharacteristic and would be an indicator of possible excessive trading. Excessive trading, also known as churning, is a classic example of unethical conduct because the practice favours the interests of the Dealing Representative at the expense of the client's interests.

Excessive trading is any practice whereby a Dealing Representative executes a trade or multiple trades in a client's account where the trade(s) will have little or no economic benefit for the client and where there is little or no rationale for the trade(s) other than to generate commissions or other benefits for the Dealing Representative. Churning is often connected to activity that involves an excessive amount of trading which "turns the book" over in the account(s). Other examples of churning involve situations where clients are invested into commission-generating transactions which have little or no rationale, for example trades in and out of investment funds with deferred sales charges (DSC).

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Example

Hari Prasad recommends to his client to redeem units in a Deferred Sales Charge (DSC) fund he holds. However, there is a penalty for redeeming the units before seven years. He advises the client to pay the DSC redemption fee and buy another DSC fund which generates commissions for Hari.

The Compliance Department determines that the transactions are unsuitable and not in the best interest of the client. The transactions are unwound, Hari is required to pay for the associated costs and losses, and he receives a Warning Letter from his dealer for excessive trading.

Excessive trading is a breach of the MFD Rules. You are strictly prohibited from engaging in excessive trading or churning.

Personal Financial Dealings and Control or Authority over Client Accounts

Personal financial dealings with clients will often create a conflict of interest that potentially impairs you in your duties and obligations. For this reason, many of these activities are conflicts of interests that should be avoided, are not permitted, or are outright prohibited.

You must not enter into personal dealings with your clients without prior approval by your dealer.

You are strictly prohibited from engaging in the following personal financial dealings with clients:

- acting under a Power of Attorney (POA), as trustee or executor, or otherwise having full or partial control or authority over the client's portfolio or financial affairs
- lending to clients
- borrowing from clients
- private investment schemes
- entering into a private settlement with a client (for example, to resolve a dispute)

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Lesson 5: Registration Requirements

Introduction

Before you are permitted to sell securities to the public, you must be registered with the appropriate provincial/territorial securities regulators. This lesson provides information about the requirements for registration and describes the steps you must follow to become registered.

This lesson takes approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- explain registration under securities legislation
- explain the client mobility exemption
- describe the registration process
- explain the National Registration Database (NRD)
- explain the Passport System
- discuss the requirements to report material changes
- explain suspension and reinstatement of registration
- explain the registration categories and the products permitted

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Registration

Under securities legislation, every firm and individual must be registered if they are in the business of trading or advising in securities. In order to conduct business in securities, you must become registered as a Dealing Representative with the securities regulators. Your dealer will become registered first and then they will sponsor your registration. You may not, under any circumstances, open client accounts or offer investment funds or any other investment products to clients unless your registration has first been approved by the securities regulators.

You must become registered with the securities regulator in each province and territory where you will have clients. Before you can conduct business as a Dealing Representative in any given province or territory, you must apply to the securities regulator in that jurisdiction and be granted registration approval. This applies regardless of where your client was located when they opened their account or whether or not there is trading in the account.

Client Mobility Exemption

Where you have clients that move to another jurisdiction, the client mobility exemption provides a limited exception to allow you to continue dealing with those clients without becoming registered in the new jurisdiction. The exemption only applies where existing clients move to another jurisdiction, not where Dealing Representatives move. Clients under the exemption are known as "eligible" clients.

In order to rely on the client mobility exemption, you must observe the following conditions:

- your mutual fund dealer must be registered in the new jurisdiction (known as the local jurisdiction)
- you must have no more than five (5) clients in the local jurisdiction
- your dealer must disclose to eligible clients that you are exempt from registration in the local jurisdiction and are not subject to the requirements of securities law in that jurisdiction

Where permitted by your dealer, you may deal with up to five (5) eligible clients in each jurisdiction where you are not registered, after which registration in the jurisdiction is required. Registered firms are limited to a maximum of ten (10) eligible clients. Some registered firms, specifically those with large organizations, disallow the exemption altogether due to this limitation.

Example

Tony has been handling Erica’s portfolio for the last five years while she resided in Ontario. After her recent marriage, Erica moves to New Brunswick. Erica wants Tony to continue handling her account, and wants Tony to handle her husband Robert’s portfolio as well. Tony does not have any other clients in New Brunswick.

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Tony can use the client mobility exemption to continue handling Erica's portfolio so long as his firm allows the exemption. However, Tony cannot open a new account for Robert's portfolio because the Client Mobility Exemption is only permitted for existing clients, not for acquiring new clients. In order open an account for Robert, Tony must become registered in New Brunswick.

Registration Process

The registration of mutual fund dealers involves a 2-step process where they must:

1. become registered under the securities regulator(s) of the province(s) and territories
2. become a member of the Canadian Investment Regulatory Organization (CIRO)

You will automatically become an Approved Person under CIRO once your registration is sponsored by your firm and approved by the securities regulator.

The registration process consists of seven steps:

Registration Process		
Step	**Who does it?**	**Description**
1	Dealing Representative	**Preparation for Registration** • Obtain the qualifications for registration: proficiency, integrity, and financial condition • Obtain proficiency: pass a recognized qualification exam such as the Canadian Investment Funds Course (CIFC) exam.
2	Dealing Representative	**Select a firm to sponsor you** • Enter into an employment or agency relationship with a firm that will sponsor your registration application
3	Dealing Representative	**Registration Application** • Complete Form 33-109F4 • Complete other documents and schedules required by CIRO • Complete the RCMP Records Request/Reply Form (authorizes the RCMP to investigate and determine if you have a criminal record) • Complete the documents required by your firm including those for outside activities, dual occupations, agency agreements, etc.

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Registration Process		
Step	**Who does it?**	**Description**
4	Registered Firm (Mutual Fund Dealer)	**Perform Due Diligence on the Applicant** • Review registration application documents • Conduct background checks to determine if the individual is a suitable candidate for sponsorship
5	Firm's Authorized Firm Representative (AFR)	**National Registration Database (NRD)** • Submit the application(s) for registration on NRD
6	Provincial/Territorial Securities Regulators	**Registration Review** • Conduct a review of the application for registration • Conduct background checks • Approve or refuse registration
7	Dealing Representative	**New Registrant Training and Supervision** • Complete the First 90 Days Training Program administered by your dealer • Undergo the First 6-Month Supervision and follow the procedures for the pre-approval of new accounts and trades

Registration Approval

If your registration is approved, notification of approval will be sent to you by email and your registration will be displayed on the website of the Canadian Securities Administrators (CSA).

Example

Neil has been working with ABC Investments Inc. for the last 5 years in an unregistered position. He has recently passed the CIFC exam and his mutual fund dealer has submitted his application for registration in Ontario.

Neil is very eager to call clients and start selling. However, he needs to wait until the Ontario Securities Commission approves his registration.

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National Registration Database (NRD)

Form 33-109F4 is filed electronically through the National Registration Database (NRD), a web-based system operated by the Canadian Securities Administrators (CSA). NRD contains registration information for registered firms, such as mutual fund dealers, and individuals, such as Dealing Representatives. NRD allows electronic filing of applications, notices, and other regulatory information. Use of NRD is mandatory for filings in all jurisdictions. If you are applying to be registered as a Dealing Representative in more than one jurisdiction, a single electronic filing on NRD is sufficient.

Firms can review the status of their registration applications online through NRD. Electronic filings on NRD are made by the firm's Authorized Firm Representative (AFR), an individual designated by the firm to administer NRD filings. Once your registration application has been filed on NRD, it will be processed under the CSA's Passport System.

The Passport System

The Passport System streamlines the process for regulatory filings with the provincial and territorial securities regulators including those for registration application.

Under the Passport System, in most cases, applications for registration in multiple jurisdictions need only be reviewed by the principal regulator. The other regulators in the Passport System will follow the decision of the principal regulator. For Dealing Representatives, the principal regulator is generally the regulator in the jurisdiction where the Dealing Representative's office is located. For firms, the principal regulator is the regulator where the firm's head office is located.

Example

ABC Investments has its Head Office in Calgary, Alberta. Bill, a Dealing Representative with ABC, works in their Vancouver, British Columbia office. ABC wants to apply for registration for Bill in both British Columbia and Alberta. Under the Passport system, ABC will need to make an application to the British Columbia Securities Commission since Bill's working office is in BC, even though the sponsoring company's head office is in Alberta.

There is an exception to this rule. If your principal regulator is **not** the Ontario Securities Commission (OSC) and you apply to be registered in Ontario together with one or more other jurisdictions, you may need to deal with 2 regulators. Because the OSC is not a member of the Passport System, it may opt out of the decision of the principal regulator and carry out its own review. However, the reverse does not apply. If your principal regulator **is** the OSC and the OSC approves your registration, the other securities regulators will accept your registration approval.

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Refusal of Registration

The securities regulators may deny registration to any firm or individual that they consider a risk to investors and/or the capital market. If a firm or an individual fails to satisfy the standards for proficiency, integrity, and/or financial condition, the securities regulators may deem the applicant not fit for registration and their registration may be refused. Examples of reasons for registration refusal could include unacceptable past history in the securities industry, other integrity or conduct issues, or criminal record.

Annual Filings

A registrant's registration is considered permanent unless suspended, revoked, cancelled, or surrendered by either the firm or the securities regulator(s). Dealers are not required to renew registration annually; however, the dealer is required to pay certain fees and file certain forms to maintain registration. In addition to the fees payable to each of the securities regulators, the dealer must also pay an annual user fee to the National Registration Database (NRD) for each registered individual of the firm listed on the NRD system. These fees are due on December 31st of each year, paid in advance for the following year.

You must pay registration fees each year in every jurisdiction where you are registered. Failure to pay the annual fees can result in automatic suspension of your registration.

Reporting Material Changes

You are required to update your NRD file whenever there is a change to the information that you filed when you became registered. You do this by filing *Form 33-109F5 Change of Registration Information* on NRD through your dealer.

Changes that must be filed with the securities regulator(s) within 10 days include changes to your:

- name
- residential address
- citizenship
- registration jurisdictions
- registration categories
- proficiency
- location of employment
- current employment, other business activities, officer positions held, and directorships
- previous employment and other activities
- resignations and terminations
- criminal disclosure (e.g. fraud or theft)
- civil disclosure
- financial disclosure (e.g. bankruptcy)

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Suspension

Your registration will be suspended if:

- your employment or partner/agency relationship with your sponsoring firm is terminated
- your annual fee to the securities regulator remains unpaid for more than 30 days after the due date
- CIRO revokes or suspends your approval as an Approved Person
- a provincial/territorial securities regulator suspends your registration

If your registration is suspended, you are no longer permitted to conduct any registerable activities such as opening new client accounts or trading in securities. However, you remain a registrant and continue to be subject to the jurisdiction of the securities regulators. A suspension remains in effect until the regulator reinstates or revokes your registration.

Registration Reinstatement when Changing Dealers

If you leave your dealer, your registration as a Dealing Representative is automatically suspended until it is reinstated or revoked. If you seek automatic reinstatement of your registration at a new firm, you must do so within 90 days of leaving your former firm. Your registration may be automatically reinstated if you transfer to a dealer in the same province/territory and join the new dealer within 90 days of leaving your former dealer.

You are not permitted to conduct any registerable activities such as opening new client accounts or trading in securities until your registration has been reinstated by the securities regulators.

If you join another sponsoring dealer more than 90 days after leaving your previous firm, you cannot seek automatic reinstatement. You must submit a new application for registration and go through the entire registration process again.

Investment Products You Can Offer

Dealing Representatives are restricted to the investment products and activities dictated under their firm's registration category. Registration category impacts the investment products you may offer. If you are registered as a Dealing Representative for a mutual fund dealer, you will generally be able to trade in prospectus mutual funds and deposit products such as guaranteed investment certificates (GICs). You may need to pursue further proficiency, registration, or licensing in order to offer investment products beyond mutual funds and deposit products.

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Registration Categories

Registrant	Firm	Permitted Products	
Dealing Representative	Mutual Fund Dealer	• mutual funds • deposit products including Guaranteed Investment Certificates (GICs) Where the firm permits and additional proficiency, licensing, policies, and procedures may also be prescribed: • exchange-traded funds • alternative mutual funds • hedge funds • segregated funds • principal protected notes (PPNs) • money market instruments (T-Bills, commercial paper) • government bonds and strip bonds (federal, provincial, territorial)	
Dealing Representative	Exempt Market Dealer	• exempt securities (prospectus exempt)	
Registered Representative	Investment Dealer	Trades and provides investment advice	All securities, both prospectus and exempt, including: • equities (common and preferred shares, rights, warrants) • fixed income (government and corporate money market instruments, debentures, bonds, strip bonds, etc.) • mutual funds, alternative mutual funds, hedge funds, and other investment funds • structured products (including PPNs) • derivatives including options and futures
Investment Representative		Trades but does not provide investment advice	

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Depending on the products that you intend to offer, registration in more than one category may be necessary. For example, a Dealing Representative who wants to sell mutual funds and exempt market securities will need to become registered with either:

- a firm which has both a mutual fund dealer and exempt market dealer; or
- an investment dealer.

Approved Products

Regardless of registration category, you are limited to the approved list of investment products and strategies published by your firm. Under the Know Your Product (KYP) obligation, you are prohibited from offering investment products or investment strategies that have not first been approved by your dealer.

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Summary

Congratulations, you have reached the end of Unit 2: Registrant Responsibilities.

In this unit you covered:

- Lesson 1: Ethics and Standard of Conduct
- Lesson 2: Compliance
- Lesson 3: Conflicts of Interest
- Lesson 4: Compliance Issues and Prohibited Practices
- Lesson 5: Registration Requirements

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 2 **Quiz** button.

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Unit 3: Know Your Client, Know Your Product, and Suitability

Introduction

As a Dealing Representative, you need to follow a rigorous process to determine which products are suitable for your client. This unit describes the suitability requirement and the steps that you must take to ensure that you are making suitable recommendations.

This unit takes approximately 1 hour and 30 minutes to complete.

Lessons in this unit:

- Lesson 1: Overview of the Suitability Process
- Lesson 2: Know Your Client (KYC)
- Lesson 3: Know Your Product (KYP)
- Lesson 4: Suitability
- Lesson 5: Strategic Investment Planning
- Lesson 6: Dealing with Older and Vulnerable Clients

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Lesson 1: Overview of the Suitability Process

Introduction

Dealing Representatives are obligated to ensure that the orders they accept, recommendations they make, and other investment actions they take are suitable for their clients.

This lesson takes approximately 5 minutes to complete.

At the end of this lesson, you will be able to:

- explain the obligations in the suitability process
- define Know Your Client (KYC)
- define Know Your Product (KYP)
- define suitability

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What is the Suitability Requirement?

As a Dealing Representative, you have a regulatory obligation to *know* the client, *know* the product, and to form an opinion as to whether the investment product or strategy is suitable for the client.

When you are considering offering or recommending an investment product or investment strategy to a client, you are obligated to first:

- learn the essential facts about the client
- learn the essential facts about the investment product and/or investment strategy
- determine whether the investment product and/or investment strategy is suitable for the client

The Know Your Client (KYC), Know Your Product (KYP), and suitability obligations are among the most fundamental obligations in securities regulation. These requirements play a central role in the protection of investors. As a Dealing Representative, the KYC, KYP, and suitability obligations are your primary obligations to your clients along with your obligation to deal fairly, honestly, and in good faith with clients.

Under the obligation, you must ensure that each order you accept and each recommendation you make for any account of a client is suitable for the client. You must diligently carry out each of the 3 steps in the suitability process and be able to evidence that you did so.

This brings us to the fourth step, which is to document everything that you do in writing, either on paper or in a computer document. You should do this concurrently with the other steps. In other words, you should document every action as you perform it.

Documentation is essential for the following reasons:

- It protects you from disciplinary or regulatory action. Documentation provides a trail of your actions and enables your Branch Manager, your dealer's Compliance Department, and possibly inspectors from the Canadian Investment Regulatory Organization (CIRO)[4] to satisfy themselves that you complied with the suitability requirement.

[4] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

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- It protects you from allegations the client can bring against you. If a client makes money, they will not likely complain. However, if a client loses money as a result of an investment, they may complain or even sue. In such cases, the documentary trail you retain will be the best evidence to show that you acted diligently.

- You are required to document the reasonable basis for your suitability determinations and how you have met your obligation to put the client's interest first.

Example

Your client, Tim, is 72 years old. His investment needs and objectives are to earn income and preserve his capital, and he has $100,000 to invest over a five-year time horizon. Tim has a risk profile of low.

You have performed due diligence in researching the different products. Based on Tim's investment needs and objectives and other KYC criteria, you recommend a portfolio of fixed income products matching the five-year time horizon that will provide Tim with a regular flow of income, without risking depreciation in his portfolio.

There are no investment products that are suitable or unsuitable in general terms. Suitability can only be determined when a given client's KYC information and the investment product's KYP information are considered. The fixed income products recommended in the example above match the client's investment needs and objectives, risk profile, time horizon, and other essential criteria identified in the suitability process. When considering the best option for the client, you have an obligation to put the client's interests first when making your suitability determination.

IMPORTANT NOTE: The suitability obligation cannot be satisfied merely by disclosing to the client the risks involved with an investment product or strategy. Disclosure of an investment's risk does not, in any way, negate your obligation to Know Your Client, Know Your Product, and make an appropriate suitability determination.

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Lesson 2: Know Your Client (KYC)

Introduction

As a Dealing Representative, you have a responsibility to collect and consider essential information about your clients in order to fulfill your suitability obligation. The basis for gathering this information is the Know Your Client (KYC) rule. KYC is step 1 in the suitability process.

This lesson takes approximately 40 minutes to complete.

At the end of this lesson, you will be able to:

- discuss the Know Your Client (KYC) obligation
- explain the New Client Application Form (NCAF)/Know Your Client (KYC) Form
- explain identification requirements, personal circumstances, and financial circumstances
- explain investment needs and objectives, investment knowledge, risk profile, and time horizon
- discuss client-specific KYC and KYC for multiple accounts and joint accounts
- discuss new account review and approval
- explain KYC confirmation and KYC updates

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What is Know Your Client?

The objective of the Know Your Client (KYC) rule is to ensure that the essential facts about a client are known so that the information can form a basis for determining whether investment recommendations will be suitable for them. Under the KYC rule, it is your responsibility to collect and consider essential information about your clients in order to ensure that they are well served by investments that suit their individual financial needs.

Step 1: Know Your Client (KYC)

Under the KYC obligation, you are required to collect and consider essential information about your clients, as set out in Mutual Fund Dealer Rule 2.2.1[5], Know Your Client. In order to satisfy your KYC obligation, you are expected to take reasonable steps to:

- establish the identity of the client
- ensure that you collect and consider sufficient information about the client's:
  - personal circumstances
  - financial circumstances
  - investment needs and objectives
  - investment knowledge
  - risk profile
  - time horizon

You are also required to collect important information as required under other laws and regulations including legislation governing tax reporting, Proceeds of Crime (Money Laundering) and Terrorist Financing, and privacy.

[5] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

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Why Gather KYC Information?

The KYC, KYP, and suitability obligations are the most fundamental and important duties of every Dealing Representative. Knowing your client is not merely checking boxes on a form; it involves having meaningful conversations with your clients that allow you to truly know and understand their means, needs, limitations, circumstances, finances, and investment goals. Otherwise, you will not be able to make suitable recommendations or provide adequate service to your clients.

Example

John, a Dealing Representative, has two clients:

1. Thomas is a 30-year-old bank manager with an annual income of $75,000. He is interested in growth-oriented products, has a 35-year time horizon, and a high risk profile.
2. Martha, 65 years old, has just retired. She is interested in capital preservation and income-generating products. She has a 7-year time horizon and a low risk profile.

Recommending high-risk funds may be suitable for Thomas, but unsuitable for Martha.

Your KYC Responsibilities

Under regulatory requirements, you are expected to:

- have a meaningful interaction with the client during your KYC process
- discuss with the client their role in keeping KYC information current
- tailor the KYC process to reflect the nature of the relationship with the client
  - For example, the regulators expect that extensive KYC information will be required if you are offering an ongoing and fully customized service or an investment product or strategy that is illiquid or highly risky.

The regulators expect you to help your clients understand KYC terminology, inquire about any noted KYC responses which appear inconsistent, and help clients define their investment needs and objectives. You are expected to be particularly conscientious in your KYC discussions with vulnerable or unsophisticated clients.

The KYC requirement is an ongoing obligation. It does not end after the initial KYC is recorded and considered when the new account is opened. You are responsible for periodically reviewing and updating the KYC information on file for your clients.

The KYC obligation cannot be delegated, for example to a third party such as a referral agent.

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New Client Application Form (NCAF)

The KYC process starts with the *New Client Application Form* (NCAF) which must be completed for each new client account that is opened. Complete KYC information must be collected when new accounts are opened and must be documented in the NCAF, also referred to as the KYC Form.

In cases of disputes, the KYC Form will customarily be reviewed by regulators and lawyers to ascertain whether you knew the client and recommended suitable investments. However, investigation into suitability disputes will go beyond the information that is collected on the KYC Form, specifically if the information on the form appears unreasonable given the client's circumstances.

The NCAF/KYC Form should be completed, signed, dated, and then reviewed and approved by your dealer. The client should receive a signed copy of the NCAF/KYC Form for their records. Dealer approval by a designated officer, partner, director, or Branch Manager should be completed no later than one business day after the initial transaction in the account.

KYC Information

In order to collect the necessary KYC information, most NCAF/KYC Forms include the following sections:

- identification
- personal circumstances
- financial circumstances
- investment needs and objectives
- investment knowledge
- risk profile
- time horizon

Identification

Under the KYC obligation, you have a duty to establish the identity of each client. Where there is any cause for concern, you are required to make reasonable inquiries as to the reputation of the client. Under Companion Policy (CP) 31-103, s. 13.2, the regulators establish their expectations of registered firms and Dealing Representatives in their role as “gatekeepers” to the capital market. As part of their gatekeeper role, firms and Dealing Representatives:

- are required to establish the identity of, and conduct due diligence on, their clients
- should not, by act or omission, facilitate conduct that brings the market into disrepute

These obligations to establish and confirm a client's identity are synonymous with the legislation under the Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTFA).

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Personal Circumstances

The obligation to learn the essential facts about each client includes learning about their personal circumstances. A client's personal circumstances have an impact on their investment needs and include those elements below.

Personal Circumstances
• age, date of birth • address and contact information • civil status/family situation (e.g. marital status) • number of dependents • other persons who are authorized to provide instructions on the account • other persons who have a financial interest in the account

For clients who are not individuals, the KYC information below must be collected and replaces the Personal Circumstances section above for individual clients.

KYC for Clients who are not Individuals
• legal name • head office address and contact information • type of legal entity (i.e. corporation, trust, etc.) • form and details regarding the organization of the legal entity (i.e. articles of incorporation, trust deed, other constating documents) • nature of business • persons authorized to provide instructions on the account • details of any restrictions on the authority of the persons authorized • other parties who have a financial interest in the account

Age

A client's age is important for several reasons:

- There is a legal age of majority in each province. Agreements, including the purchase of mutual funds and other securities, entered into by people who are not of legal age may not be enforceable.

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- There are age restrictions for certain accounts, such as Registered Education Savings Plans (RESPs) and Registered Retirement Savings Plans (RRSPs).

- Your client's age ties in closely with his or her short-, medium- and long-term financial goals.

For instance, a 25-year-old single man with 40 years until retirement will likely have different investment needs and objectives, and risk profile than a man of 60 who is approaching retirement.

Financial Circumstances

The client's financial circumstances are a key component of the client's KYC information and includes those elements below.

Financial Circumstances
• employment status and occupation • annual income • net worth • financial assets and liquid assets • liquidity needs • whether the client is using leverage or is borrowing to invest • creditworthiness

Employment Status and Occupation

Occupation and employment status are important factors when assessing suitability. For example, clients who are retired and living on a fixed income will have different objectives than those in their high-income earning years. In addition, some clients may have cyclical jobs or may be paid by commission. In these cases, their income may vary dramatically from year to year. It is important to recognize the potential gaps in clients' income and work with them to meet both short-term liquidity needs and longer-term investment requirements.

Income

Annual income is critical to assessing an individual's financial condition and can be an indicator of whether they can withstand volatility or loss. Generally, clients with a low income are expected to have a lower risk profile, a higher need to preserve their principal, and increased liquidity requirements because significant life events (losing a job, buying a house, etc.) may result in the need to depend on their investments.

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For example, if the client depends on the income generated by their investments to live on, then their financial circumstances would likely not allow for exposure to the potential losses from higher-risk securities. It would also not be generally suitable for a client with a low income to be invested through a leveraging strategy. On the other hand, a client earning $100,000 from employment with a healthy net worth would likely be less affected by a loss.

Annual income should include income from all relevant sources and should be collected as a number or by using reasonable ranges. Income is commonly recorded in ranges on the KYC Form as illustrated below.

Income
○ <$75K ○ $75,001 - $100K ○ $100,001 - $199,999 ○ $200K - $300K ○ >$300K

Net Worth

Net worth denotes wealth and is critical in assessing a client's financial condition. Knowing a client's net worth helps you to determine the client's resources and ability to invest, as well as any tax implications that may affect investment choices. At higher levels of net worth, reducing tax exposure may become a priority. As with any tax-driven investment or strategy, investors should consult with a qualified tax professional to determine if the tax benefit is appropriate for them.

Net worth should be calculated as the estimated liquid assets plus fixed assets less estimated liabilities. Net worth should only include assets of the client and his or her spouse.

Net Worth
(Liquid Assets + Fixed Assets) - Liabilities = Net Worth

You should have a detailed view of the client's net worth in order to be able to recommend suitable products. The regulators expect you to take reasonable steps to obtain a breakdown of financial assets, including capturing information about the client's investments held outside of the dealer, in order to assess over-concentration.

Net worth, along with all other KYC factors including income, risk profile, and age, are particularly important factors to consider when reviewing whether a leveraging strategy is appropriate for a client.

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For leveraged accounts, you must record the details of the net worth calculations, specifying:

- **liquid assets:** cash, investments
- **fixed assets:** residence, real estate
- **liabilities:** debts, mortgages, loans, credit cards

Net worth is commonly recorded in ranges on the KYC Form as illustrated below.

Net Worth
○ <$50K ○ $50,001 - $100K ○ $100,001 - $200K ○ $200,001 - $500K ○ $500,001 - $1M ○ >$1M

Example

Your client, Cheri Jones, has a net worth of $10 million. She is interested in reducing the amount of tax she is required to pay. Regardless of tax benefits, any investment product that is considered for Cheri must be approached first and foremost as an investment and whether it is suitable for her.

Example

An investor wishes to purchase high-risk speculative investments. However, his financial situation indicates that he is not in a position to tolerate the potential losses from such an investment. As a Dealing Representative, you have an obligation to discourage the client from selecting investments that may have a material negative impact on his financial situation.

Liquidity

Liquidity needs are an important aspect of a client's financial circumstances. Ascertaining a client's liquidity needs includes determining:

- the extent to which a client wishes or needs to access all or a portion of their investments to meet their ongoing and short-term expenses

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- financial obligations or major planned expenditures
- whether the client has any other means to cover their expenditures
- the frequency of any required withdrawals

Leverage

You are required to determine whether a client will use leverage or borrow to invest and collect and compute additional information about their financial circumstances in order to determine whether leverage will be suitable including:

- net worth
- liquid net worth
- total debt service ratio (TDSR) - the client's monthly payment obligations as a percentage of the client's monthly income
- percentage of net worth (%NW) - the client's loan amount as a percentage of the client's net worth

The purpose of collecting this additional financial criteria is to assess the client's ability to meet debt obligations and to assess whether leveraged investing will be suitable for the client.

Investment Needs & Objectives

The investment needs and objectives and risk profile of a client are the most critical criteria in assessing whether an investment or investment strategy is suitable for a client. The client's investment needs and objectives define the ultimate goal that the client has for the invested capital and the result they aspire to achieve with the investment.

Investment needs and objectives are often categorized as follows:

Investment Needs and Objectives		
Need/ Objective	**Description**	**Investments**
Safety	Investors seeking safety have an objective to preserve their principal investment and are less concerned with capital appreciation.	Investment selection could include cash, guaranteed investment certificates (GICs), and money market investments.

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Investment Needs and Objectives		
Need/ Objective	**Description**	**Investments**
Income	Investors seeking income have an objective to generate current income from their investments and are less concerned with capital appreciation.	Investment selection should include securities that will generate a regular stream of income such as money market, fixed income, and dividend income investments.
Balanced	Investors seeking a balanced investment have an objective to seek a combination of income and growth.	Investment selection should typically include a combination of fixed income and equity investments.
Growth	Investors seeking growth have an objective to achieve capital appreciation from their investments and are less concerned with generating current income or preserving the safety of their principal.	Investments could include those that invest in equities including Canadian equity, US equity, certain international equity, and Canadian small-cap equity investments.
Aggressive Growth/Speculation	Investors seeking to speculate have an objective to achieve maximum returns and are willing to take on a high level of risk in exchange for the return they hope to achieve.	Investments could include sector and specialized investments such as those invested in emerging markets, science and technology, natural resources, and precious metals, and investments that engage in venture capital and speculative trading strategies such as labour-sponsored venture capital funds, commodity funds, and certain alternative mutual funds and hedge funds that engage in speculative trading strategies.

Clients may have multiple objectives, for example, income and growth. In such cases, you must be able to identify the relative importance of each objective within the account. Most dealers accommodate this by offering a KYC Form that allows the investment needs and objectives to be recorded in percentages.

As set out in CP 31-103, s. 13.2, when determining a client's investment needs and objectives, the regulators expect you to provide clients with the opportunity to express their investment needs and objectives in non-technical terms that are meaningful to them, for example:

- save for retirement

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- increase wealth by a certain percentage in a specific number of years
- invest for the purchase of a home
- invest for the post-secondary education of children

The CP goes on to state:

“Depending on the nature of the relationship with the client, and the securities and services offered by the registrant, it may be appropriate to set out investment goals for a client’s account or portfolio which may be done by developing an investment policy statement. Where investment goals are agreed upon with a client, they should be set out in terms that are specific and measurable. A registrant should consider setting out investment return assumptions that would be required to meet the client’s investment needs and objectives. A registrant should also periodically update the client on progress towards any goals set for their account or portfolio.”

Investment Knowledge

Investment knowledge reflects the client's comprehension about investments and investing including their understanding about the:

- financial markets

- the relative risks and limitations of various types of investments, and how the level of risk taken affects potential returns

You are expected to learn about your client’s level of awareness and previous experiences with finances and investments. Specifically, you should be alert where investment knowledge flags inconsistencies with other KYC criteria. For example where a client indicates that they have limited investment knowledge and experience, but also indicate that they have a “high” risk profile.

Investment experience reflects how much investing the client has done previously and the nature and complexity of those investments. Investment experience is not the same as investment knowledge. You cannot assume that because a client has previous investment experience, they have investment knowledge. Some clients may know a great deal about investing and various types of investments without ever having made investments. Other clients may know very little, despite having numerous previous investments.

Becoming familiar with your client’s level of investment knowledge helps you to determine the types of investments you might recommend. Investment knowledge is a particularly important factor to consider when determining whether higher-risk investment products or leverage are appropriate for a client. The more complex or the higher the risk of the investment or strategy, the more sophisticated the client should be.

Investment experience is usually recorded on the KYC Form in a section where the client's previous investments can be listed or checked off using tick boxes. Investment knowledge is commonly recorded by selecting from a list of options on the KYC Form as illustrated below.

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Investment Knowledge	
Definition	The client's knowledge about investments and investing
Options	o Novice (Low) o Fair (Average) o Good (Above Average) o Sophisticated (High)

Risk Profile

When determining the suitability of an investment product or investment strategy for a client, perhaps the most important factor is the client's risk profile. Along with investment needs and objectives, risk profile is the most important key component of the client's KYC.

Establishing a client's risk profile involves the determination of two (2) criteria:

1. The client's risk tolerance: the client's willingness to accept risk
2. The client's risk capacity: the client's ability to endure potential financial loss

Risk tolerance and risk capacity are separate considerations that together make up the client's overall risk profile. The client's risk profile should reflect:

- the lower of: (1) the client's risk tolerance and (2) the client's risk capacity

Assessing a client's risk capacity requires you to have an understanding about the client's personal and financial circumstances, investment needs and objectives, and other KYC criteria that would impact their ability to sustain investment losses. When assessing a client's risk capacity, you should consider the client's:

- liquidity needs
- debts
- income
- assets
- the weighting of the client's investment(s) in relation to their overall financial position
- age
- life stage

A client's risk profile changes with age, employment status, income, investment knowledge, marital status, and other priorities in life.

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Example
Jim is 35 years old, married with two children, and has an annual income of $80,000. His risk profile is reported as “high”. If Jim loses his job, with the resulting loss of income, his risk profile will likely change.

It is important that you do not confuse risk profile with other KYC criteria such as income, net worth, and time horizon. While you should consider these criteria and discuss them with your clients to assist them in understanding risk and return, the criteria should not override the client's final assessment of their actual willingness and ability to accept risk. Consider, for example, a client who may be very affluent but loses sleep when his publicly listed stocks are volatile causing him to panic and sell at the wrong time.

The regulators expect you to document the questions and answers you use to establish your clients’ risk profiles. Assessing a client’s risk profile is sometimes determined by using tools such as questionnaires. You should be fully aware of the questionnaires approved by your dealer and follow your firm’s policies and procedures for determining risk profile.

Dealers are expected to have definitions related to risk profile. Some mutual fund dealers have 3 levels: Low, Medium, and High. Other dealers have 5 levels: Low, Low-Medium, Medium, Medium-High, and High. The definitions for risk profiles will be established in the firm’s policies and procedures and Relationship Disclosure Information (RDI).

Generally, the summary in the table below is true.

Risk Profile		
Risk Profile	**Description**	**Investments**
Low	The low risk rating applies to investors who are risk averse and are willing to accept lower returns in order to preserve their principal.	Investments under the low risk rating include assets with low volatility including cash and equivalents, GICs, money market, and certain fixed income investments.
Low-Medium	The low-medium risk rating applies to investors who are seeking a balance between safety and return on their investment.	Investments under the low-medium risk rating include investments with low to medium volatility and may include fixed income or balanced funds.

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Risk Profile		
Risk Profile	**Description**	**Investments**
Medium	The medium risk rating applies to investors who are seeking moderate growth over a longer period of time.	Investments under the medium risk rating include investments with medium volatility and may include investments in blue chip and mid-cap equities such as Canadian dividend, Canadian equity, U.S. equity, and certain international equity investments.
Medium-High	The medium-high risk rating applies to investors who are seeking long-term growth.	Investments under the medium-high risk rating include investments with medium to high volatility and may include those that invest in smaller companies, such as Canadian small-cap equities, and specific market sectors or geographic areas.
High	The high risk rating applies to investors who are growth oriented and are willing to accept significant short-term fluctuations in portfolio value in exchange for potentially higher returns.	Investments under the high risk rating include investments with high volatility and may include those that invest in specific market sectors or geographic areas such as emerging markets, science and technology, natural resources, precious metals, labour-sponsored venture capital funds, commodity funds, and certain alternative mutual funds and hedge funds that engage in speculative trading strategies.

Like investment needs and objectives, risk profiles are often expressed in percentages which are recorded on the client's KYC Form/NCAF. Once you have determined your client's risk profile, you will record it into the KYC Form/NCAF.

Risk versus Return Conflicts

You should be aware that, in some cases, there will be a mismatch between the risk a client is willing or able to accept and the return the client expects. Higher expected returns come with inherently higher risk. Under these circumstances, you may be tempted to assess a higher risk profile than you should in an attempt to meet the client's return expectations. Resist this temptation.

Where a client's desire for returns does not align with their risk profile, you are expected to follow prescribed steps to protect the client from assuming too much risk, as set out in CP 31-103, s. 13.2.

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Resolving conflicts between a client's expectations and risk profile

As set out in CP 31-103, s. 13.2:

"Registrants should not override the risk a client is willing and able to accept on the basis that the client's expectations for returns cannot otherwise be met given the risk profile associated with their KYC responses. The registrant should identify any mismatches between the client's investment needs and objectives, risk tolerance and capacity for loss. The questions at the source of this conflict should be revisited with the client. If a client's goals or return objectives cannot be achieved without taking greater risk than they are able or willing to accept, alternatives should be clearly explained such as saving more, spending less or retiring later.

Where after discussion, it is determined that the client does not have the capacity or tolerance to sustain the potential losses and volatility associated with a higher risk portfolio, the registrant should explain to the client that their need or expectation for a higher return cannot realistically be met, and as a result, the higher risk portfolio is unsuitable. The interaction with the client and end results should be properly documented."

Example

Janice is a single mother of two children, ages 4 and 6. She has meager savings of $20,000 and works two part-time jobs to make ends meet. So far, Janice has preferred to place her savings in fixed income products with low risk. However, extremely low rates of interest provide her with a very low rate of return on her savings.

She realizes that higher yields will be possible only if she places her savings in higher-risk investments. During her meeting with you, she expresses an interest in amending her risk profile level to "high".

Although Janice says she is comfortable with high risk, her ability to sustain the loss of her savings is still very low. You should advise her to keep her risk profile as low.

Assessing Risk Profile

Errors in correctly assessing a client's risk profile can result in significant consequences including client complaints, enforcement proceedings, and legal action. One of the most common allegations made in client complaints to the Canadian Investment Regulatory Organization (CIRO) is that the assessment of the client's risk profile was incorrect. Clients allege that the risk profile indicated on the KYC form was higher than that which the client asserts is his or her actual risk profile.

You may face disciplinary action if you make an inappropriate recommendation for a client's risk profile level. For these reasons, it is critical that you make a diligent effort to determine your clients' risk tolerance, risk capacity, and resulting risk profile and retain documented evidence of how you came to your risk profile determinations. It is also important that you do not substitute your own judgment for that of the client when it comes to risk profile. If the client is not comfortable with a certain level of risk, the KYC should reflect that decision.

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Time Horizon

Time horizon refers to the length of time the client will hold the investment before they will need to liquidate it and access the funds. Time horizon can range from short to long periods and will depend on the client's individual objectives. Time horizon is customarily recorded in ranges on the KYC Form similar to the ranges in the table below.

Time Horizon	
Definition	The time from the purchase to the time when the client will need to access a significant portion of the money invested
Options	< 1 Year (Short-Term) 1 - 3 Years (Short-Term to Medium) 3 - 5 Years (Medium) 5<10 Years (Long) 10<20 Years (Very Long) 20+ Years (Very Long)

Determining Time Horizon

The length of the client's investment time horizon impacts the types of investments that may be suitable for the client. Clients with a longer time horizon may have a greater degree of flexibility in investment selection, whereas clients with a short investment time horizon may be limited to conservative investments.

It is incorrect to assume that all young clients have long time horizons, and all older clients have short time horizons. You must know your clients and their individual needs. A client's time horizon should be feasible and reasonable given the client's liquidity needs, age, investment needs and objectives, risk profile, and other KYC criteria.

Example

Your client Tom is 30 years old and has a mutual fund portfolio of $100,000. He invests $2,000 monthly. Tom's objective is to use these funds to buy a house for $250,000.

Essentially, Tom's time horizon is around 5 to 6 years, as his portfolio may very well be worth $250,000 by then.

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A client's time horizon is important when considering investment products, including the fee structures of the investments. It is considered unsuitable to recommend to a client an investment product that has a fee schedule of longer duration than the client's time horizon. Likewise, investment products that have maturities or liquidity restrictions for a period longer than the client's time horizon would be considered unsuitable. It is generally unsuitable to recommend a fund with a deferred sales charge (DSC) if the client has a time horizon that is shorter than the DSC schedule[6]. At a minimum, a client's time horizon should never be three years or shorter if invested in funds with a DSC.

Example

Gerard, a Dealing Representative, recommends to his client Ritesh, age 27, a fixed income product yielding 4% per annum, maturing in 7 years and non-redeemable prior to then.

Ritesh has a stated time horizon of 5 years, at which point he plans to use the funds as a down payment to buy a house.

Although this investment fits with Ritesh's high risk profile and investment needs and objective for growth, the 7-year maturity date is longer than Ritesh's stated time horizon. It is therefore unsuitable.

Client Specific KYC

Every individual is unique and the KYC process is meant to expose each client's uniqueness so that you can better understand them and provide investments that are suitable for them. You should never take the reverse approach of recording KYC information for a client to match it to an investment product or strategy that you recommend. Such conduct is improper and in breach of your suitability obligation.

Clients with Multiple Accounts

Some clients prefer to have a separate account for specific purposes, such as for saving for a home, for children's education, or for retirement. These clients usually open multiple accounts at the same dealer.

In cases where a client has multiple accounts, you are required to collect KYC information separately for each account. This will ensure that the investment needs and objectives, risk profile, and time horizon will be properly aligned with the purpose of each of the accounts.

[6] Effective June 1, 2022, DSC Funds are banned in all jurisdictions. However, DSC Funds distributed prior to the ban may be held by investors and associated redemption schedules may apply.

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Example

Jacolyn has two accounts. One is for her Registered Retirement Savings Plan (RRSP), and one is a non-registered account where she saves money for her down payment for her first home she plans to buy next year.

Since Jacolyn is only age 33 and won't retire for 20+ years, the time horizon for her RRSP will be much longer than the time horizon for her non-registered account. Jacolyn will also likely have very different investment needs and objectives and risk profiles for her non-registered account since she has a shorter time horizon and she doesn't want to risk the principal investment.

Joint Accounts

In the case of accounts jointly owned by two or more individuals, the KYC information for income and net worth may be collected for each owner or on a combined basis, but it must be clear which method you have used.

Investment needs and objectives, time horizon, and risk profile should relate to the account and should not be collected separately for each individual account holder.

KYC Confirmation

Registered firms and individuals are required to take reasonable steps to have their clients confirm that their KYC information is correct. As such, you are required to follow your dealer's policies and procedures with respect to:

- obtaining confirmation from clients of the accuracy of KYC information collected
- documenting clients' confirmation of KYC
- providing written confirmation to the client of KYC information updated/confirmed
- providing the opportunity for clients to correct their KYC information

Keeping KYC Current

Obtaining KYC information when the account is opened is only the first step. KYC information forms the basis for determining whether trades in securities and other investment actions are suitable for investors. For the information to be of continuous use for suitability, it must be kept up to date. Over time, clients' circumstances and investment needs and objectives may change as major life events take place. As such, you are required to make reasonable efforts to keep KYC information current.

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KYC must be reviewed with clients and, where necessary, updated no less than:

- when there is a material change in the client's circumstances and/or KYC criteria
- every 36 months at minimum

You are required to update KYC information whenever you become aware of a material change in the client's circumstances including:

- marital status
- birth of children
- desire to purchase a home
- financial status including employment, income, and net worth
- all changes to KYC information including risk profile, investment needs and objectives, and time horizon

When you open a new account for a client, advise them to inform you promptly if there is any material change in their information. Be sure to provide examples of material changes, as explained above, so that there is no misunderstanding. The regulators also expect you to make reasonable inquiries to determine if there has been a significant change to a client's KYC information.

In addition, at least once a year, your dealer is required to send written notification to all clients to ask them:

- if there has been any material change in the information previously provided
- if their circumstances have materially changed

Dealers normally send these notifications to clients along with their year-end client account statements.

Your Branch Manager, or other designated person responsible for approving new accounts, must also approve all material changes to client information.

Client Refusal

There may be situations that arise where a client refuses to provide their KYC information, for example on the basis of privacy. However, you cannot accept client accounts or properly fulfill your suitability obligation on this basis. You must carefully and clearly explain why the KYC information is needed and how it will be used. If the client is still resistant after you have explained the need to collect this information, you need to either:

- Reject the client's business, or

- Contact your Compliance Department. They may be able to help you with explaining to the client that the account cannot be opened without obtaining the information required under regulatory requirements.

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Your firm's Policies and Procedures Manual will likely provide guidelines for dealing with a client who refuses to disclose KYC information to you. In some circumstances, the client's failure to provide you with the required KYC information may constitute an attempted suspicious transaction that must be reported to the Financial Transactions and Analysis Centre of Canada (FINTRAC).

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Lesson 3: Know Your Product (KYP)

Introduction

As a Dealing Representative, it is your responsibility to learn the essential facts about the investment product and/or investment strategy when you make a suitability determination. Know Your Product (KYP) is step 2 in the suitability process.

This lesson will take approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of the Know Your Product (KYP) obligation
- explain the obligations of the dealer for product due diligence
- explain product due diligence and the factors considered in the analysis of an investment product or investment strategy
- explain your restrictions and responsibilities as a Dealing Representative

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Step 2: Know Your Product (KYP)

The Know Your Product (KYP) requirement is an integral part of the overall suitability assessment. It is important because you cannot align suitable investments to a client's investment needs and objectives unless you fully understand the features of the product. Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation.

Under the KYP obligation, you are required to take reasonable steps to understand the investment's:

- structure
- features
- risks
- initial and ongoing costs
- the impact of those costs

Although the KYP obligation is triggered when you recommend an investment product to a client or take any other investment action, you and your dealer may be deemed to implicitly recommend a product by merely having the product on your shelf or by advertising and promoting the product. The KYP obligation extends to all proprietary products of the firm and those of any related and connected issuers.

The Firm's Product Due Diligence

The KYP process begins with the registered firm, for example the mutual fund dealer. The KYP obligation requires the firm to review and approve all investment products and investment strategies before the firm or its Dealing Representatives make them available to clients. In doing so, the firm is required to take reasonable steps to understand the investments' structure, features, risks, initial and ongoing costs, and the impact of those costs. Registered firms are further required to monitor approved investment products and strategies for significant changes and update their product records accordingly.

In addition, guidance from the regulators further advises member firms to establish:

- a "committee", often referred to as the "Product Review Committee", to carry out the product due diligence obligations of the firm; and
- a methodology for ranking the risk of investment products.

The firm is required to develop an investor profile for investment products and strategies that have been approved by the firm. The investor profile must include the elements summarized below.

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Investor Profile	• investors who the product would be suitable for
	• investors who the product would not be suitable for
	• investor profiles including:
	  - personal circumstances
	  - financial circumstances
	  - investment needs and objectives
	  - risk profile
	  - time horizon
	  - investment knowledge
	• concentration limits
	• other restrictions/controls

Where an investment product or strategy is included on your mutual fund dealer's list of approved products, it does not:

- diminish in any way your obligation to learn the essential facts about each investment product and investment strategy and determine whether the investment products/strategies are suitable for your clients

- indicate that a product/strategy is suitable for all clients

Your Know Your Product (KYP) Obligations

Your dealer's due diligence and approval of a product does not relieve you of your duty to understand the product to ensure that it is suitable for your clients. Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation. In doing so, you are required to take reasonable steps to understand the investments' structure, features, risks, initial and ongoing costs, and the impact of those costs.

Under Companion Policy (CP) 31-103, s. 13.2.1, you are also expected to:

- apply a more detailed consideration of investment products and strategies that are more complex or risky

- have a general understanding of the types of securities that are available through your firm in order to fulfill your obligation to consider a reasonable range of alternatives when making a suitability determination

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- take reasonable steps to understand investments when acquired by transfer-in or by client-directed trade

Under your KYP obligations, you are required to:

- have a thorough understanding of the investment product and/or investment strategy
- clearly explain the investment product/strategy to clients

In your explanation to clients, you are expected to cover the features summarized in the table below at minimum.

Product Features	
General Features and Structure	• investment mandate/objective • return • use of leverage • conflicts of interest • time horizon • overall complexity of the product
Risks	• liquidity risk • redemption risk • other product risks (e.g. from underlying derivatives, structured product risks, etc.)
Costs & Fees	• commissions • sales charges • trailer fees • management fees • performance fees • incentive fees • referral fees • embedded fees • executive compensation

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Product Features	
Suitability	• how the product is suitable for the client

It is important for you to understand any product you recommend, but it is equally important to ensure that your client understands the product. Although your client may profess to know the product, you may need to ask some probing questions to verify that your client understands the information you have provided.

Example

Your client James was told by his friend that the only way to improve interest yield in a low-interest-rate environment was to invest in Principal Protected Notes (PPNs). James comes to your office and asks you to sell his existing redeemable Guaranteed Investment Certificate (GIC) and invest in a 5-year PPN. You begin to explain to James the features of the product, but he interrupts you by saying that he knows what a PPN is. As long as the principal is secured, he is comfortable. You realize that James does not have much liquidity in his portfolio except for the GIC. You ask him a few questions, inquiring if he is aware that unlike his existing GIC, the PPN is not redeemable. Based on this discussion, James chooses not to buy the PPN.

If a particular investment product is not aligned with a client's investment needs and objectives, risk profile, time horizon, financial circumstances, or other KYC criteria, it should not be recommended to that client. Before submitting a transaction, you should be fully confident that the client, and not just you, understands the product and how it fits into their overall plan and goals. It is especially important that the client understands the downside risks of the investment so that if disaster befalls it, the client will have understood that it was a possibility.

It is important that you document all details of your discussions with your clients. The documentary trail that you retain should include the product features listed above, the range of alternatives available through your firm, how the investment product/strategy fits into their planned goals, and the downside risks.

While your dealer is not required to approve investment products that are transferred into their clients' accounts or those that are held as a result of a client-directed trade, they are required to assess and understand the investment products within a reasonable time after the transfer or trade. You are required to take reasonable steps to understand those investments acquired by transfer-in or client-directed trade in order to fulfill your suitability obligation.

Unapproved Investment Products and Strategies

Under the KYP obligation, you are prohibited from offering investment products or investment strategies that have not first been approved by your dealer.

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Lesson 4: Suitability

Introduction

Once you have learned the essential facts about your client and the essential facts about the investment product and/or investment strategy, you are required to determine whether the investment product/strategy is suitable for the client. Making this suitability determination is step 3 in the suitability process.

This lesson will take approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of the suitability obligation
- explain suitability determination, account type suitability, and concentration risk
- explain how unsuitable outcomes should be treated
- explain how client-directed (unsolicited) trades should be treated
- explain leverage suitability

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Suitability

The KYC and suitability obligations are the most fundamental and important duties of every Dealing Representative. The suitability obligation requires you to *know* the client, *know* the product, and to form an opinion as to whether the investment product is suitable for the client.

You are obligated to ensure that any orders you accept and any recommendations you make are suitable based on the essential facts relative to your clients. However, the suitability obligation extends beyond orders and recommendations. You are required to make a suitability determination every time that you:

- open a new client account
- accept an order
- make a recommendation
- purchase, sell, deposit, exchange, or transfer investments for a client's account
- make a recommendation or decision to continue holding an investment
- take any other investment action for a client
- accept a client account (e.g. from another Dealing Representative)
- become aware of a material change in a client's circumstances
- become aware of a change in an investment within the client's account
- conduct a review of the client's KYC information
- exercise discretion, where permitted, to take any of the actions above

Example

Gavin is a Dealing Representative and he learns that his client, Eddy, has fallen ill and now has a shortened life expectancy. This unfortunate development has an impact on Eddy's risk profile, time horizon, and investment needs and objectives. Therefore, Gavin needs to evaluate the suitability of the investments in Eddy's account given his new circumstances.

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Example

Isar is a Dealing Representative and his client Nazma had a well-paying job when she opened her account. After some time, Isar learns that Nazma has lost her job and because of the weak economy, she feels that it is unlikely that she will find an equivalent job. The job loss has a significant impact on Nazma's income. Therefore, Isar needs to evaluate the suitability of the investments in Nazma's account given her new circumstances.

The regulators take the view that suitability determination should encompass not only the particular attributes of a security, viewed in isolation, but also the proposed *quantum of the investment amount* or the proposed *trading strategy* involving the security. Canadian Securities Administrators (CSA) Staff Notice 31-336 provides the following example as guidance:

"...an investment in a high-risk security may be suitable for a client where the proposed investment would represent a small portion of the client's investment portfolio. However, an investment in the same security may not be suitable for the client where the proposed investment would represent a substantial portion of the client's portfolio or where the proposed investment strategy involves leverage."

You cannot, under any circumstances, delegate your suitability obligation to another party such as an unregistered individual, an administrative assistant, a referral agent, or a registrant at another firm.

Step 3: Suitability Determination

Under NI 31-103 and CP 31-103, you are required to satisfy a number of standards when making a suitability determination:

1. assess suitable options;
2. apply the "Client's Interest First" standard; and
3. document the basis for each suitability determination.

Assessing Suitable Options

Suitability determination starts with the identification and assessment of suitable options for a client. This involves the objective analysis of the Know Your Client (KYC) information for the client and the Know Your Product (KYP) information for the investment product or strategy. The impact of the proposed action on the client's account must then be weighed to consider whether the account will be suitable for the client, after the action has been completed.

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Assessing Suitable Options	
Know Your Client Information	**Know Your Product Information**
Risk Profile	**Risk rating from the:** • offering documents, for example: - prospectus, Fund Facts, ETF Facts, offering memorandum, etc. • the registered firm's product approval notice
Investment Needs and Objectives	**Investment mandate/features based on the:** • offering documents, for example: - prospectus, Fund Facts, ETF Facts, offering memorandum, etc. • the registered firm's product approval notice
Time Horizon and Age	**Time factors based on the:** • duration, maturity date • redemption features, schedules, restrictions • liquidity **Impact of costs:** • costs of disposing of the investment product • the impact of those costs on performance returns
Investment Knowledge	**Structure and complexity**

After considering what the impact will be when the proposed action has been completed, the KYC and KYP information should be compared and used to consider whether:

- the KYC and KYP are aligned and the investment product/strategy is deemed suitable after the consideration of reasonable alternatives available through the registered firm
- the concentration of any investments within the account(s) are over-weighted
- the investments in the account provide sufficient liquidity to meet the client's liquidity needs

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Suitability assessment commonly starts with a comparison of the risk of the investment product/strategy compared to the risk profile of the client. This risk-based approach is an effective starting point and there are also correlations that can be made by comparing the KYC and KYP information related to investment objectives, time horizon, age, and investment knowledge. While these elements are key in determining suitability, all aspects of the client's KYC, the investment's KYP, and the client's existing holdings need to be considered.

Example

Joe is a 27-year-old single male, working as a computer programmer, making $65,000 annually. Joe lives with his parents and manages to save a major portion of his income. Joe has a high risk profile. His investment objective is growth of capital since he wants to have the flexibility to achieve major financial goals later in life. He plans to work overseas to better his prospects and wants to keep his portfolio fairly liquid so that he can invest overseas in the country where he will work.

Joe is young, with a good income, and high risk profile. However, his time horizon is short and uncertain due to his possible relocation. Suitable investment products for Joe are liquid investments such as money market funds, treasury bill funds, or redeemable GICs.

As set out in Companion Policy (CP) 31-103, s. 13.3, suitability assessment:

- cannot use the risk rating of a security as the only input in determining its suitability
- cannot be determined only on a trade-by-trade basis

Suitability assessment must encompass a portfolio approach in order to consider the impact of factors such as risk, concentration of investments, and liquidity in the client's portfolio. Where client accounts are held separately in multiple accounts (e.g. client name), and not in one portfolio, you are expected to consider how any recommendations or other investment actions in one account will materially affect the client's investments across all their accounts.

"Client's Interest First" Standard

Following the assessment of suitable options for the client, you are then required to apply the "Client's Interest First" standard. Therefore, in addition to the consideration of KYC and KYP factors, you must assess whether the proposed action is one that puts that client's interest first.

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"Client's Interest First" Standard

As set out in CP 31-103, s. 13.3:

"…when making a suitability determination, registrants must put the client's interest first, ahead of their own interests and any other competing considerations, such as a higher level of remuneration or other incentives."

The regulators give further guidance in the CSA's Client Focused Reforms Frequently Asked Questions (FAQ), s.18:

"Among other considerations, putting the client's interest first requires registered firms and each of their registered individuals to avoid being influenced to make a self-interested choice in the particular circumstances of any given investment action. Examples of factors that might have such an influence include sales commissions, targets for sales volume or assets under management, client retention, and relationships with issuers. If any of these material conflicts of interest are present, the firm must have policies and procedures for addressing them as discussed above. Where material conflicts are present, they must be considered before any investment action is taken. In that context, the test is whether the registrant has put the client's interest first."

The FAQ goes on to state:

"It also includes circumstances where a registrant has a limited product shelf. In some instances, a registrant will have to decline to provide a product or service to a client in order to put the client's interest first."

The obligation to put the client's interest first when determining suitability requires you to consider, amongst other factors, the potential (or actual) impact of costs on the client's return on investment. Costs include all direct and indirect costs, such as:

- fees
- commissions
- charges
- trailing commissions
- any other costs associated with a proposed action

You are expected to assess both the:

- relative costs of the options available to clients
- impact of those costs on the client's overall return from any compensation paid, directly or indirectly, to you

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Some investment products or strategies that are assessed to be suitable for a client, based on KYC and KYP, may not meet the "Client's Interest First" standard.

Example

On July 5, 2021, Tyler Davidson (Davidson) and the Mutual Fund Dealers Association of Canada (MFDA)[7] consented to a Settlement Agreement. Under the agreement, Davidson admitted that he recommended a trade in a deferred sales charge (DSC)[8] investment fund that needlessly subjected his client to a seven-year redemption schedule and other costs, while it generated commissions for himself.

The case involved Davidson's sale of the DSC version of an investment fund to a client when the investment amount qualified her for the lower-cost I-Program version of the fund.

By investing the client in the DSC version of the fund, the client was needlessly subjected to a 7-year redemption schedule, higher management fees by 20-35 basis points, redemption fees of $17,200, additional redemption fees on subsequent related transactions in the client's registered retirement savings plan (RRSP), and interest charges on a line of credit that the client took to avoid further redemption fees on amounts needed for a down payment on a home. Davidson earned $15,346 in commissions by investing the client in the DSC version of the fund. In doing so, Davidson violated MFDA Rules 2.1.1 (Standard of Conduct), 2.1.4 (Conflicts of Interest), and 2.2.1 (Suitability).

The Settlement Agreement was accepted by the MFDA Hearing Panel on July 12, 2021 and the following settlement terms were ordered: **A one-month prohibition, a fine of $22,500, and costs of $5,000.**

As set out in CP 31-103, s. 13.3, where you are not able to offer a client an investment option that is suitable and puts the client's interests first because the option is not available through your dealer, the regulators expect you to decline the client's account.

Documenting the Basis for Suitability Determination

Once a suitability determination has been made, you are required to document the reasonable basis for your suitability determination and how you have met your obligation to put the client's interest first including the:

- relevant facts
- key assumptions

[7] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

[8] Effective June 1, 2022, DSC Funds are banned in all jurisdictions. However, DSC Funds distributed prior to the ban may be held by investors and associated redemption schedules may apply.

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- scope of data considered
- analysis performed

Account Type Suitability

You and your firm are subject to the suitability obligation for all proposed investment actions, including opening an account for a client. As outlined in CP 31-103, s. 13.3(c), you are expected to ensure that the opening of a new account:

- is suitable for the client
- puts the client's interest first

In determining whether an account is suitable for a client and whether the account puts the client's interest first, you are expected to consider the:

- type of account recommended
- compensation option(s)
- nature of the service offered to the client
- investment strategies such as leverage
- features and associated costs for the account, for example:
  - fee-based accounts
  - commission-based accounts

Before the account is opened, you are expected to explain the features and associated costs of different types of accounts that are available to the client at the firm.

Concentration

Concentration is an integral element in the consideration of suitability. It is considered high risk to have portfolios which hold assets that have high correlations to each other such as investment type, sector, asset class, geographic region, risk, etc. From the perspective of mutual funds, the funds themselves are highly diversified investments. As such, there is minimal risk of being concentrated into a single security, small number of securities, single issuer, or small number of issuers. However, exposure to concentration can arise from being over-weighted in certain industry sectors or geographic regions. These types of correlations reduce diversification and increase risk from concentration.

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The securities regulators take the view that suitability should encompass not only the attributes of a security, viewed in isolation, but also the proposed *quantum of the investment amount* or the proposed *trading strategy* involving the security. As such, portfolios which are over-concentrated could pose suitability concerns. Under National Instrument (NI) 31-103, s. 13.3, *Suitability Determination*, "the impact of the action on the client's account, including the concentration of securities within the account and the liquidity of those securities" must be factored into any suitability determination.

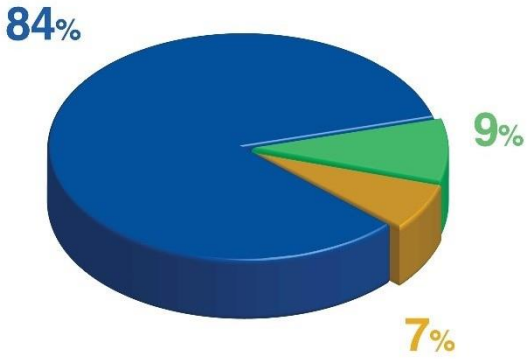
Companion Policy (CP) 31-103, s. 13.3 further explains the regulators' expectations with respect to concentration:

"…registrants should assess whether the client's investments are over-concentrated in:

- illiquid exempt market securities as compared to more liquid publicly traded securities,
- securities of a single issuer, or group of related issuers, as compared to a broadly- based portfolio of issuers, or
- securities of an issuer, or group of related issuers, that provides exposure to a single industry or asset class…"

In order to effectively consider concentration, you should follow your firm's policies and procedures to consider:

- the type of security
- the asset class of the security
- the sector of the security
- the geographic region of the security
- liquidity restrictions
- the risk of the security
- the client's portfolio as a whole, in consideration of the above



Over-concentration in an investment, sector, geographic region, etc. can impact the risk and liquidity in a client's account. You are expected to consider concentration in your analysis of the investments that will be suitable for your clients. You are also expected to document reasonable concentration thresholds to ensure that a client's investment does not exceed concentration thresholds that would result in the investment being unsuitable. Generally speaking, the higher the concentration, the more detailed your analysis and justification should be. The onus will be on you to demonstrate and evidence how and why any concentrated positions are suitable for the client(s) and put the clients' interests first.

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Example

Devora is a Dealing Representative with FundsLink Investments Ltd., a mutual fund dealer. Devora has completed an in-depth review of the Spector Small Cap Resources Fund which has a "high" risk rating. Devora is impressed by the portfolio manager's rigorous processes and she is convinced that the fund is a good investment.

Devora's client, Kalina, is also a great believer in the Spector Small Cap Resources Fund. In fact, Kalina already has a portion of her portfolio invested in the fund.

Even if Devora is convinced that the Spector Fund is suitable for Kalina, she needs to think twice before advising Kalina to buy additional units of the fund. First, Devora needs to consider the investments held within Kalina's account. Since Kalina already has a portion of her portfolio invested in the Spector Small Cap Resources Fund, it is possible that if she buys additional units, she may become over-weighted in high-risk funds or she will become exposed to concentration risk from the resource sector.

Tax-Advantaged Investments

Certain mutual funds, such as capital class funds and return of capital funds, enjoy certain tax benefits which may enhance their potential return or defer tax payable. In some cases, the approach of using leverage may also be seen as advantageous from a tax perspective. However, regardless of any tax benefits, investment products and investment strategies must be approached first and foremost as an investment. A decision to invest should be based primarily on an appraisal of the merits of the investment. The investor's risk profile is a critical factor in this respect, in particular their ability to absorb losses.

As with any tax-driven investment or strategy, investors should consult with a qualified tax professional to determine if the tax benefit is appropriate for them.

Treatment of Unsuitable Outcomes

Where you determine that an action in a client's account will result in an outcome that is unsuitable for the client, you are required to advise the client accordingly, make recommendations to address the suitability issue(s), and maintain evidence of your recommendations. Alternative recommendations to address suitability issue(s) may include:

- selling the unsuitable investment (where applicable/permitted)
- not buying the unsuitable investment (in the case of a proposed transaction)
- cancelling or reversing the trade in the unsuitable investment at no cost to the client

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- recommending other, off-setting trades or transactions in the account to bring the account "in line" with the client's KYC and objectives

- reviewing and updating the client's KYC information, if appropriate (where the client's circumstances and/or objectives have changed)

Making unsuitable recommendations or failing to address unsuitable outcomes may have severe consequences for you and for your firm, which may include:

- client complaints against you and your dealer
- internal investigation by your dealer
- an external enforcement investigation by the securities regulator(s)

When you are required to re-assess suitability under one of the suitability triggers (e.g. when a KYC review is triggered, when you become aware of a change in an investment, etc.), there may be limitations to the options to rectify what has become an unsuitable investment. In some situations, the investment could be illiquid or have constraints on the redemption rights of the investor. As per guidance provided in the CSA's Client Focused Reforms Frequently Asked Questions, s.49, in such cases you would be expected to:

- take "reasonable steps" to explore the possibility of redeeming the investment

- in consideration of penalties, discounts, or other factors that would be detrimental to the client's interest, make a determination of whether a redemption would be suitable

- document the basis for the suitability determination and the discussion with the client

- take this fact into account when making future recommendations for the client, including any additional investments

Client-Directed Trades

Client-directed trades, also known as unsolicited trades, are those which are initiated by the client without recommendation from the Dealing Representative or the firm. The suitability requirement applies to all trades, whether they are initiated by the client or recommended by you. If you receive instructions from a client which, in your view, will result in an unsuitable outcome, you are required to:

- inform the client that the transaction is not suitable and provide the basis of your suitability determination

- recommend alternative action which is suitable

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- obtain recorded confirmation of the client's instruction where they proceed with the action despite the suitability determination

You and your dealer are under no obligation to accept a trade from a client that is determined to be unsuitable. Whether a firm should accept or refuse such a trade is an internal policy decision and you will need to consult with your firm. If your client proposes a trade or action that you believe is unsuitable, and you are unclear on how to proceed after providing the required suitability determination and alternatives, then you should consult your firm for guidance.

Example

Edwin, a client, asks Steve, his Dealing Representative, to sell all units of his Treasury Bills Fund, which represents 50% of Edwin's portfolio. He asks Steve to invest the proceeds of the sale in precious metals, as he overheard someone at a cocktail party say that precious metals are about to soar.

Steve informs Edwin that precious metals are unsuitable for him because they do not align with Edwin's KYC information. Steve recommends that Edwin invest in conservative investments which are in line with his risk profile and investment needs and objectives, but Edwin is firm in his decision.

Steve reviews his firm's Policies and Procedures Manual and follows the process set out for completing unsuitable unsolicited trades. This includes getting a signed acknowledgement from Edwin that states:

- the transaction was unsolicited
- Steve made a suitability determination and advised Edwin that the proposed transaction was unsuitable for Edwin
- Steve recommended conservative investments as an alternative to the precious metal investments
- Edwin proceeded with the transaction despite Steve's suitability determination and alternative recommendations.

Disclosure

It is important that you understand that disclosure does not justify an unsuitable recommendation. For example, a recommendation to a client with a "low" risk profile to purchase a high-risk investment or to use leverage to invest is unsuitable, even if the client is provided with disclosure that shows the investment or leverage strategy is high-risk. Thus, the fact that a client has been given a risk disclosure does not justify an unsuitable recommendation.

There are several cases in civil litigation which ruled against the defendants on the basis that they relied on disclosure. Disclosure does not relieve you from your suitability obligation.

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Example

Donato is a client with a "medium" risk profile. His Dealing Representative, Remigio, recently reviewed the BRICStar Emerging Markets Fund and he is convinced of its merits as an investment within a diversified portfolio. The fund is a high-risk investment, as stated in its prospectus.

Remigio considers whether he should recommend the BRICStar Emerging Markets Fund to Donato. His recommendation would be accompanied with full disclosure that the fund is high-risk and he would give a copy of the prospectus to Donato.

Remigio should NOT do this. He should not recommend a high-risk security to a client with a "medium" risk profile, even if he gives Donato the fund's prospectus and disclosure that states that the fund is high-risk. Disclosure of a fund's high risk does not justify selling it to a client with a "medium" risk profile.

Leverage

Leveraging by an investor involves buying securities using a portion of his or her own money and borrowing the rest. By borrowing money, an investor can make a larger investment, which can lead to greater potential returns. However, since markets and securities decrease as well as increase in value, leveraging can also result in greater losses.

Leverage is a complex strategy which increases the risk of investing. The higher the leverage, the greater the risk. Mutual Fund Dealer Rule 2.2.6 specifically requires Dealing Representatives to determine whether investment strategies where clients "borrow to invest" are suitable for those clients. As such, when you recommend or become aware of leveraged investing, you are required to:

- determine whether leverage is suitable for the clients
- inform the client about the risks of leverage and provide them with the prescribed *Leverage Risk Disclosure*

Leverage Suitability

If you plan to offer leverage as a part of your practice, you should realize that leverage is a complex strategy that increases the risk of investing. You have an added responsibility to assess the suitability of leverage before you recommend the strategy to your clients or accept orders from your clients who invest with borrowed funds.

As with any other suitability assessment, the determination of whether leverage is suitable for a client begins with the objective analysis of the KYC and KYP information. Summarized below are the key KYC and KYP criteria that you should consider when assessing leverage suitability.

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KYC	KYP
• employment status and occupation • income • net worth • financial assets and liquid assets • liquidity needs • age • risk profile • investment needs and objectives • time horizon • investment knowledge	• lending institution • amount borrowed • loan type • interest rate • loan payment type (i.e. interest only, principal and interest) • term • previous investment loans

Making a determination about whether leverage is suitable for a client starts with an assessment of whether the investment using borrowed funds is appropriate for the client given their investment needs and objectives, risk profile, and time horizon. Leverage suitability also requires a more thorough and comprehensive analysis of the client's personal and financial circumstances in order to determine how borrowing to invest will impact the client's liquidity and financial needs.

Mutual fund dealers that permit leveraged investing will have detailed policies and procedures for how leverage suitability is to be assessed and approved. Typically, the dealer will have a Leverage Worksheet which is to be used to calculate and assess a number of criteria including the client's:

- income
- total debt service ratio ("TDSR") - the client's monthly payment obligations as a percentage of the client's monthly income
- percentage of net worth ("%NW") - the client's loan amount as a percentage of the client's net worth
- age
- risk profile
- investment needs and objectives
- time horizon
- investment knowledge
- employment status
- liquidity needs

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Firms that permit leveraged investing will have detailed policies and procedures for how leverage suitability is to be assessed and approved. You are responsible for being fully aware of and following your firm's policies and procedures for assessing leverage suitability and documenting your suitability determinations.

Example

Catherine, an elderly widow in her 80s, has a need for regular income, a low risk profile, and a short time horizon. Peter Sly, a Dealing Representative handling her account, without discussing any aspects of suitability, recommends that she undertake a leverage strategy to boost her depleting income. Peter suggests a few aggressive global funds which have had impressive returns during the past three months. Peter has breached Mutual Fund Dealer Rule 2.2.6 by recommending a leveraging strategy without conducting a leveraging suitability assessment to determine whether leverage is suitable for Catherine. Based on her age, investment needs, risk profile, and time horizon, it is very likely that leverage is not suitable for Catherine.

Example

Joe, one of your clients, wants to undertake a leveraged transaction by borrowing funds and investing them in precious metals. He heard from his friends that precious metals have fallen significantly in value, and the only way for them to go now is up.

You need to complete a leveraging suitability assessment, and if you determine that leverage is suitable for Joe and in his best interests, you must follow your dealer's policies and procedures for the review and approval of leveraged transactions. Where your firm requires, you will need to obtain pre-trade approval before you proceed.

If approved by your dealer, you can then prepare a balanced presentation for Joe about the associated options and risks. You must inform Joe, and document the fact that you disclosed to him, the following that:

- the value of the leveraged portfolio may fall below the value of the loan
- investment risks as well as gains are magnified
- interest costs may exceed the returns received
- irrespective of the outcome, Joe is responsible for repaying the loan with interest
- leverage should never be used as a tax-reduction strategy
- any conflicts of interest

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You need to ensure that Joe understands the disclosures that you provide. You must also deliver risk disclosure documents to Joe and record his acknowledgement that he received them. That said, disclosure does not negate your obligation to assess whether leverage is suitable for Joe and to make a suitability determination. Disclosure alone is also not considered sufficient to address conflicts of interest and is meant to be used in conjunction with other measures to manage conflicts of interest.

Leverage Risk Disclosure

You must provide the prescribed Leverage Risk Disclosure to all clients who invest using borrowed funds, whether you recommend the use of leverage or you become aware that the client is using leverage. When you recommend leverage, you must provide the Leverage Risk Disclosure before proceeding with any investment strategy where the client will use borrowed funds to invest. Where you do not recommend leverage, you must provide the Leverage Risk Disclosure as soon as you become aware that the client has borrowed funds to invest. However, providing the disclosure does not relieve you of your suitability obligation. It is your duty to ascertain whether leverage is suitable for any given client, regardless of the fact that you provide the Leverage Risk Disclosure.

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Lesson 5: Strategic Investment Planning

Introduction

The Strategic Investment Planning (SIP) process can help you follow a clear series of steps to help you through the process of developing good recommendations. While the SIP process is a helpful tool, you must also fully understand your suitability obligation under regulatory requirements.

Why Follow the SIP Process?

The SIP process provides a series of steps that you, as a Dealing Representative, can follow to help your clients meet their objectives. Following the process makes it easier for you to help your clients to understand and achieve their objectives, identify their desired levels of return on investment, and provide a plan to help them meet their needs and goals.

It is important to note that the SIP Process is not a prescribed obligation under regulatory requirements, although it may be a suggested practice under certain professional designations. This is unlike the KYC, KYP, and suitability requirements which are prescribed regulatory requirements under securities legislation and the Mutual Fund Dealer Rules.

NOTE: While a process offers a useful set of steps to follow, it does not guarantee that your clients will meet their objectives.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- explain the six-step Strategic Investment Planning process:
    - establish the client engagement
    - gather client data and identify objectives
    - clarify client status, problems, and opportunities
    - identify strategies and present the plan
    - implement the plan
    - monitor performance and update

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The Strategic Investment Planning Process

The Strategic Investment Planning (SIP) process consists of six steps. The six steps enable you as a Dealing Representative to enter into client engagements, understand your clients' needs and objectives, and develop and implement financial plans that aim to meet your clients' goals.

Your clients determine the level of service they are expecting from you. Some clients may retain you for the entire planning process; others may retain you only for a part of the process. For instance, a client may retain you for steps 1 to 4, in order for you to complete a financial plan.

It is essential that you keep detailed documentation throughout the financial planning process. Mutual fund dealers usually have internal processes and forms for each step in the SIP process. You should become familiar with your dealer's processes and forms.

1. Establish the Client Engagement
2. Gather Client Data and Identify Objectives
3. Clarify Client Status, Problems, and Opportunities
4. Identify Strategies and Present the Plan
5. Implement the Plan
6. Monitor Performance and Update

Step 1: Establish the Client Engagement

In this step, a potential client chooses you as his or her Dealing Representative and agrees to pay you on an agreed basis.

In addition to completing your dealer's New Client Application Form (NCAF) and providing the client with the Relationship Disclosure Information (RDI), you also formalize your relationship with the client using a Letter of Engagement, which specifies:

- your duties and responsibilities
- your client's duties and responsibilities
- the level of service you are offering
- the agreed-upon fees that your client will pay for your services

1. Establish the Client Engagement
2. Gather Client Data and Identify Objectives
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Once the Letter of Engagement is signed by both you and your client, it becomes a valid legal contract.

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Step 2: Gather Client Data and Identify Objectives

Once you are engaged as the Dealing Representative for your client, you gather as much data as possible about the client in order to best meet their needs.

Based on the information you have gathered, you and your client should work together to define, quantify, and prioritize their personal and financial goals.

This process is carried out in conjunction with the Know Your Client (KYC) obligation which requires you to learn the essential facts about each client.

1. Establish the Client Engagement
2. Gather Client Data and Identify Objectives
3. Clarify Client Status, Problems, and Opportunities
4. Identify Strategies and Present the Plan
5. Implement the Plan
6. Monitor Performance and Update

Step 3: Clarify Client Status, Problems and Opportunities

In this step, you conduct a detailed analysis of the client information you have collected, in order to:

- clarify the client's status
- identify any constraints that might affect your client's ability to meet their goals

With the information collected in Step 2, you are in a position to judge whether the client's resources are adequate to meet their financial objectives. If the client's resources are not sufficient, then you must work with them to refine their established priorities.

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Step 4: Identify Strategies and Present the Plan

Based on the client information, goals, and any constraints identified, you develop a financial plan to meet the client's objectives.

The financial plan is based on basic and realistic assumptions about financial parameters such as:

- inflation
- income tax rates
- interest rates
- anticipated rates of return

1. Establish the Client Engagement
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Any statements or illustrations about the future performance of a given investment must use reasonable estimates, and in no way may suggest that the projected results are guaranteed.

A common claim in complaints from clients relates to misrepresentations made in financial plans and illustrations. Therefore, it is very important to follow your dealer's procedures for disclaimers that must be included under regulatory requirements. Your dealer's procedures will likely require you to include a disclaimer that includes qualifying statements such as:

- the financial plan is based on assumptions made by you
- results contained in illustrations are not guaranteed
- actual performance and results may be different from the figures in the illustrations

For instance, if you base your financial plan on an assumed yield of 3% per annum (p.a.) compounded quarterly, but the portfolio manages to earn only 2.5% p.a. compounded quarterly, the actual value of the portfolio at the end of the time horizon will be less than the projected value in the financial plan.

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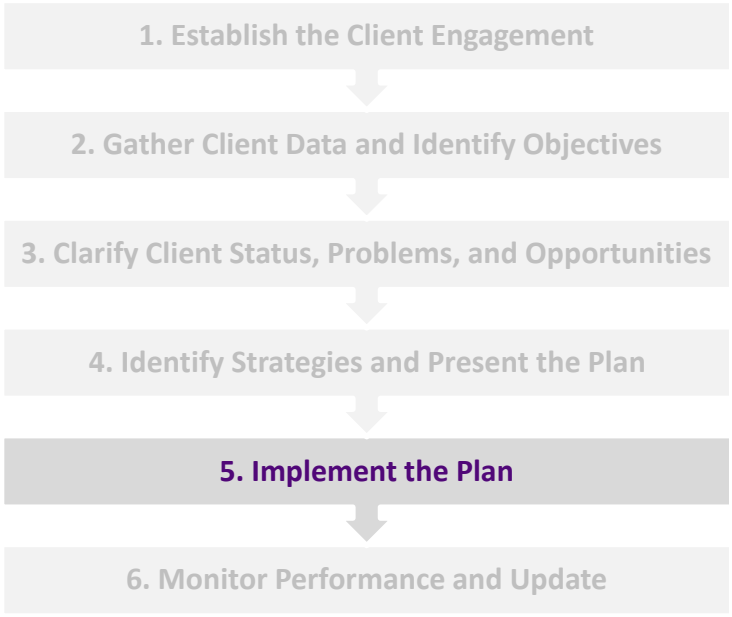
Step 5: Implement the Plan

The best investment plan is worthless unless your client makes a commitment to implementing your recommendations. Depending on the client's expected level of service, you now need to either implement the plan or guide your client should they wish to implement the plan themselves.


1. Establish the Client Engagement
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6. Monitor Performance and Update

Step 6: Monitor Performance and Update

Once the plan is implemented, it is essential to monitor the investments periodically to compare projected performance to actual performance, and to monitor variations in inflation and interest rates compared with the assumptions made during planning.

You should also review any changes in the client's personal circumstances to determine whether any changes are warranted to the client's plan.

1. Establish the Client Engagement
2. Gather Client Data and Identify Objectives
3. Clarify Client Status, Problems, and Opportunities
4. Identify Strategies and Present the Plan
5. Implement the Plan
6. Monitor Performance and Update

Under the SIP process, it is a best practice to suggest changes to the financial plan or asset allocation mix to reflect changes to the client's personal circumstances or objectives, as well as changes to general and industry-specific economic conditions.

The Letter of Engagement should clearly establish the level of monitoring the client expects you to perform. It should specify what you will do, when you will do it, and why it is being done.

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Lesson 6: Dealing with Older and Vulnerable Clients

Introduction

This lesson covers the obligations and requirements for dealing with older and vulnerable clients.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of the requirements for dealing with older and vulnerable clients
- explain the requirements for establishing a Trusted Contact Person (TCP)
- explain the requirements governing temporary holds
- discuss the firm’s policies and procedures for dealing with older and vulnerable clients

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Dealing with Older and Vulnerable Clients

Specific attention is required when dealing with investors who fall into the “senior” category, defined as individuals over the age of 65, and other vulnerable investors. Canadian securities regulators have established legislation and regulations with the purpose of protecting older and vulnerable clients.

In general, older clients are thought to have limited ability to replenish capital losses through future income from other sources. As a broad rule, older clients typically have:

- investment objectives that emphasize safety of capital and income rather than growth
- lower risk profile than younger investors
- shorter time horizons than younger investors

Notwithstanding the generalities concerning older clients, every individual is unique and the suitability process should accommodate the uniqueness of every client. However, the onus will be on you to demonstrate and evidence how and why an older client is an exception to the general rules.

Vulnerable clients are defined as those individuals who might have an illness, impairment, disability, or aging-process limitation that places them at risk of financial exploitation. Financial exploitation is when a person or company uses, controls, or deprives the use or control of an individual’s financial assets through undue influence, unlawful conduct, or another wrongful act.

Extra caution should be exercised when dealing with older and vulnerable clients, especially if engaged in higher risk investments or strategies, or those that deplete capital through withdrawals that exceed returns. Generally speaking, leverage is not typically appropriate for older or vulnerable clients due to their lesser ability to withstand losses and their diminished ability to replenish capital.

Other risks that have come to the forefront with respect to older and vulnerable clients are those involving reduced mental capacity. Older and vulnerable clients can be susceptible to physical or cognitive impairments which call into question their ability to properly understand the risks of investing and to instruct you in a meaningful way.

As a result, specific regulatory requirements have been established to place responsibility on you to:

- take reasonable steps to designate a Trusted Contact Person (TCP) for each client

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- follow your firm's procedures for placing temporary holds on accounts, where the firm permits, when you reasonably believe that the client:
  - is at risk of being exploited financially
  - does not have the mental capacity to make a financial decision for their account

Trusted Contact Person

Under National Instrument (NI) 31-103, s. 13.2.01, you have a duty to take reasonable steps to designate a Trusted Contact Person (TCP) for each client including:

- the name and contact information for the TCP
- written consent from the client to contact the TCP in prescribed circumstances

Designating a TCP for each client is meant to help clients plan and prepare for their senior years and other special challenges that could affect them including cognitive decline, diminished capacity, and financial exploitation. By designating the TCP, you and your dealer are authorized to speak to the TCP should they become concerned about the client's welfare concerning:

- financial exploitation of the client
- the client's mental capacity to make a financial decision for their account

You and your dealer are also authorized to speak to the TCP in order to ask questions about the:

- client's current contact information
- name and contact information for a legal representative of the client

TCPs must be over the age of majority and are often family members or caregivers of the client. However, those who have an interest in the client's account or assets, such as a beneficiary, or those involved in making financial decisions for the account, such as a Power of Attorney (POA), should not be designated as a TCP. Designating a TCP does not bestow any power to the TCP to make changes to the client's accounts or their financial dealings in any way. As such, the TCP should not be considered an alternative to a Power of Attorney (POA).

You are required to take reasonable steps to maintain current records pertaining to the TCP and update those records within a reasonable time when there are significant changes made to the client's KYC information.

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You should follow your firm's policies and procedures for designating TCPs, which might typically include procedures to ask clients to consider naming a TCP when:

- the new account is opened
- the KYC information is updated

Temporary Holds

Under NI 31-103, s. 13.19, firms are permitted to place a temporary hold on a client's account should they reasonably believe that the client is a vulnerable client and is either at risk of being exploited financially or at risk because they do not have the mental capacity to make the financial decision related to an instruction for their account.

By placing a temporary hold on an account, the firm may temporarily disallow a:

- withdrawal, liquidation, or transfer of cash or securities from an account
- purchase or sale of a security

Temporary holds can be applied at the transaction level, but not at the level of the entire account. A temporary hold must be limited to a specific transaction (e.g. a withdrawal, liquidation, transfer, etc.) and each transaction should be reviewed separately. Any transactions unrelated to the financial exploitation or lack of mental capacity should proceed free of hold.

Under guidance in Appendix G, Part 13 of Companion Policy (CP) 31-103 and Mutual Fund Dealer Rule 2.2.8[9], temporary holds must be approved by designated persons such as the Chief Compliance Officer or authorized and qualified supervisory, compliance, or legal personnel.

Conditions for Temporary Holds	
Condition 1: A temporary hold may **only** be placed on a client's account if the firm reasonably believes that:	• the client is a vulnerable client; and • an attempt has or will be made to exploit the client financially, or the client has already been exploited financially; or • the client does not have the mental capacity to make financial decisions related to the instruction given by the client.

[9] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

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Conditions for Temporary Holds	
Condition 2: Where a firm places a temporary hold on an account based on the foregoing, the firm must:	• document the facts that resulted in the firm's decision to place the temporary hold • promptly, as soon as possible, provide notice of the temporary hold to the client, with reasons • promptly, as soon as possible, review the facts that resulted in the firm's decision to place the temporary hold to determine if continuing the hold is appropriate • review the facts on a reasonably frequent basis to determine if continuing the hold is appropriate • within 30 days and each subsequent 30-day period determine either to: - terminate the temporary hold - proceed or not proceed with the withdrawal(s), liquidation(s), transfer(s), purchase(s), or sale(s) of securities • provide the client with notice of the firm's decision, with reasons, where it decides not to terminate the temporary hold

Where Firms are not Obligated

It is important to note that firms are not obligated to place temporary holds on accounts under regulatory requirements. Given that there is no "safe harbour" to protect registered firms from disputes should trading losses arise from unexecuted transactions, firms will need to consider the potential risks from trading losses. While safe harbours exist in other jurisdictions, such as the US, there is no such protection for registered firms in Canada. Therefore, firms will need to consider these risks when determining whether or not they will structure their programs to include temporary holds.

Recognizing Cognitive Decline and Financial Exploitation

The regulators have provided good guidance on how Dealing Representatives can recognize cognitive decline and financial exploitation. In particular, Companion Policy (CP) 31-103, provides the CSA's definitions of financial exploitation and decline in mental capacity in Appendix G of the policy. MFDA Bulletin #0797 includes

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Appendix A which summarizes the key learnings from the regulator's Seniors Summit. The appendix provides valuable information on how to recognize the "red flags" of diminished capacity and elder financial abuse from noteworthy experts in the medical, legal, financial, and regulatory professions.

Registered firms are expected to have policies and procedures for dealing with older and vulnerable clients which should include the detailed warning signs of financial exploitation and decline in mental capacity. You should be fully aware of your firm's policies and procedures on these topics.

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Summary

Congratulations, you have reached the end of Unit 3: Suitability.

In this unit you covered:

- Lesson 1: Overview of Suitability
- Lesson 2: Know Your Client (KYC)
- Lesson 3: Know Your Product (KYP)
- Lesson 4: Suitability
- Lesson 5: Strategic Investment Planning (SIP)
- Lesson 6: Dealing with Older and Vulnerable Clients

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 3 **Quiz** button.

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Unit 4: Economic Factors and Financial Markets

Introduction

As a Dealing Representative, your clients will expect you to have an understanding of the Canadian financial markets, and the economic factors that affect markets, including business cycles, government policies, and other elements.

This unit takes approximately 1 hour and 30 minutes to complete.

Lessons in this unit:

- Lesson 1: Economic Factors
- Lesson 2: Financial Markets
- Lesson 3: Canada’s Financial System

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Lesson 1: Economic Factors

Introduction

As a Dealing Representative, your clients will expect you to be familiar with economic indicators, business cycles, and government monetary and fiscal policies.

This lesson takes 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe commonly used economic indicators and how they reflect economic activity
- explain the concept of business cycles
- explain how government uses fiscal and monetary policy to stabilize or stimulate the economy

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Economic Indicators

The economic health of a region is represented by economic indicators. The three common indicators that your clients may ask you to explain are:

- Gross Domestic Product (GDP)
- Inflation Rate
- Unemployment Rate

Gross Domestic Product (GDP)

The quantity of goods and services produced by a country is one of the primary indicators of the health of the economy. Gross Domestic Product (GDP) is a measure of the total market value of all the final goods and services produced in the economy in a year. GDP is measured in dollars.

GDP values are usually referred to as either “nominal” or “real”. Nominal GDP is expressed based on current market prices, while real GDP is adjusted for inflation, to remove the effect of price increases.
An increase in real GDP is interpreted as a sign that the economy is doing well, while a decrease indicates that the economy is not working at its full capacity.

An increase in GDP typically means higher profits for companies and increased dividends or higher stock and sector related mutual fund prices for investors. On the other hand, a decrease in GDP typically indicates lower company profits and decreasing returns to investors.

Consumer Price Index (CPI)

The cost to purchase goods and services within a country is an important economic indicator. A price index measures many different prices in the economy. The most well-known and widely used price index calculated by Statistics Canada is the Consumer Price Index (CPI). To prepare the CPI, Statistics Canada tracks the retail prices of a basket of about 600 goods and services purchased by a typical household. This includes food, housing, transportation, furniture, clothing, and recreation. Items in this basket of goods and services are weighted to reflect typical consumer spending habits.

To give an accurate reflection of the price of goods and services, CPI is always calculated in relation to a base year. The current market value of this basket divided by its value in the base year and multiplied by 100, becomes the Consumer Price Index.

An increase in CPI could mean that investors have less money available to invest. It could also mean that those who rely on investment income for living expenses may find that they need to use more of their investment income to cover their basic living expenses.

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Annual Inflation

The rate of change in the price of goods and services is an important indicator of an economy's price stability. Inflation is a rise in the general level of prices in an economy over a period of time. The amount that you can buy with your dollar, called purchasing power, falls as the rate of inflation rises. If the general price level falls, it is called deflation.

The rate of change in the general price level, year over year, is called the inflation rate. On a year-to-year basis, the inflation rate is measured as follows:

Inflation Rate = (current year CPI value – previous year CPI value) ÷ previous year CPI value X 100

The following table shows the relationship between CPI and the Annual Inflation Rate. Note that the CPI is always in relationship to a base year while inflation is the year to year change in CPI.

Year	CPI	Annual Inflation Rate
Base Year	100	
1	105	(105 - 100) ÷ 100 x 100 = 5.0%
2	110	(110 - 105) ÷ 105 x 100 = 4.8%
3	115	(115 - 110) ÷ 110 x 100 = 4.6%

Distributive Effects of Inflation

A major effect of unanticipated inflation is a redistribution of real income from lenders to borrowers. Unanticipated inflation results in lenders receiving less real income and borrowers benefiting from cheaper than expected loans.

Example

Caitlyn borrows $100 from Terence in a year when prices are stable (the rate of inflation is zero) at a 2% interest rate. After one year, Terence expects to receive $2 in real income.

If prices rise by 5%, then Terence would need $105 to buy what $100 bought a year ago. The $102 he receives represents a reduction in real income of $3. On the other hand, Caitlyn has benefited from a loan now worth $105 for only $102.

The table below shows how unexpected inflation redistributes real income from lenders to borrowers.

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	No Inflation	Inflation at 5%
How much Terrence will receive after 1 year	$102	$102
Price of a $100 item after 1 year	$100	$105
Real Income for Terrence (lender)	$102 - $100 = $2 Terrence gains $2	$102 - $105 = -$3 Terrence loses $3
Who received an unexpected benefit	no one	Caitlyn (borrower)

Measures of Employment and Unemployment

The unemployment rate is the percentage of the labour force that actively seeks work but is unable to find employment. The labour force is defined as the total of all those employed and unemployed in the economy. Individuals who do not have a job and are not actively looking for one are excluded from the labour force.

The following table shows the components included and excluded from the labour force.

Included in Labour Force	Not Included in Labour Force
• Employed • Full time • Part time • Unemployed (actively looking for work)	• Retired persons • Students • Unpaid family workers • Others not looking for work

In Canada, employment and unemployment numbers are collected monthly by Statistics Canada. The unemployment rate is defined as the percentage of the labour force that is currently unemployed and actively looking for work.

The unemployment rate is a key indicator of the health of the economy. In general, when economic growth is strong, the unemployment rate tends to be low and when the economy is stagnating or in recession, unemployment tends to be higher. Variations in employment numbers can also reflect structural changes in the economy as new technology replaces labour or forces it to be employed in another way.

Unemployment and GDP typically move in opposite directions. An increase in GDP typically means lower unemployment as companies hire additional labour to meet the growing demand. Lower unemployment typically means investors have more funds available to spend, save or invest.

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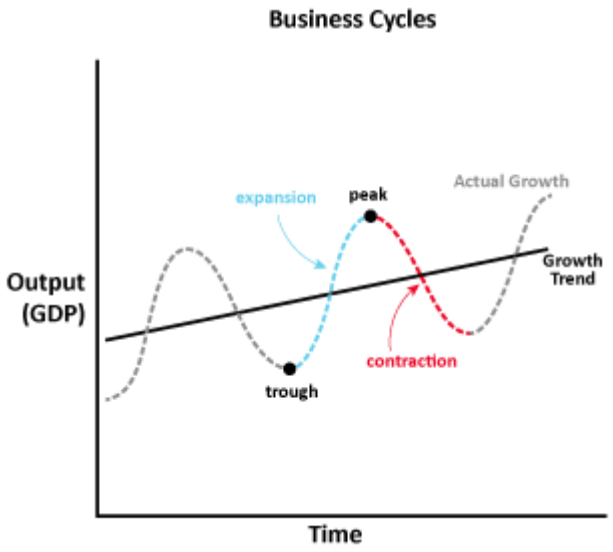
Full employment represents the highest number of both skilled and unskilled workers that a given economy can employ at any one time. In Canada, the full employment rate is considered to be less than 6% unemployment.

Business Cycles

The Canadian economy moves in cycles which include periods of economic expansion followed by periods of economic contraction. The period of economic expansion is not of the same length in every cycle. Furthermore, a period of economic expansion is not necessarily as long as a period of economic contraction. A period of at least two quarters (i.e. six months) of economic contraction is called a recession. These irregular waves in the level of economic activity are called business cycles or economic cycles.



The GDP growth rate is the change in GDP compared to the previous year and is the indicator that is often used to illustrate the economic/business cycles and to compare growth between economic regions. A period of increase in GDP followed by a period of decrease in GDP is referred to as a business cycle.

This graph shows two business cycles of economic expansion followed by economic contraction.

Over time, the GDP rate moves in an opposite direction to unemployment rate. In periods of expansion stock prices tend to rise and in periods of contraction they fall.

Fiscal Policy and Monetary Policy

Governments and central banks try to stabilize their economies and maintain high employment, steady economic growth, and price stability. There are two main tools to accomplish this: fiscal policy and monetary policy.

Fiscal Policy

Fiscal policy is the government's use of taxes, transfer payments and spending to influence the overall level of economic activity. The government controls how much tax is collected from Canadian citizens and corporations. The government also controls their spending and transfer payments. Government spending refers to the amount that the government spends on product and services. Transfer payments are payments from the government without an exchange of goods or services. Examples of transfer payments are unemployment benefits, subsidies, social security payments, and other welfare benefit payments.

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An expansionary fiscal policy is meant to stimulate economic growth through increased spending, increased transfer payments, or reduced taxes. For instance: A person's disposable income is equal to their income, less taxes plus transfer payments. Reduced taxes or increased transfer payments will increase their disposable income. This represents an expansionary fiscal policy, and eventually this sort of policy can result in increased inflation as prices adjust to new levels of disposable income.

Conversely, a restrictive or contractive policy is meant to slow down an overheating economy through reduced transfer payments, reduced spending, or increased taxes. The result of a restrictive or contractive policy is that real GDP and price levels eventually drop as economic activity slows.

Monetary Policy

The Bank of Canada serves as the central bank responsible for monetary policy. It is also the bank to the banks and for the federal government. Monetary policy is about making changes to the money supply for the purpose of changing short-term interest rates.

The duties of the Bank of Canada are to:

- regulate currency and credit in the best interests of the economy
- control and protect the Canadian dollar
- influence the level of production, trade, prices and employment through monetary action

To fulfill these duties, the Bank of Canada may do one or more of the following:

- increase (redeposit) or decrease (drawdown) the Government of Canada's deposits with the chartered banks
- participate in open market operations by buying or selling treasury bills through a designated group of investment dealers and banks
- change the bank rate to signal its intentions regarding monetary policy

If increasing demand for credit and consumer products during a period of economic expansion causes prices to move upward too rapidly, the Bank of Canada can raise interest rates. This increases the cost of borrowing money and eventually reduces the amount of money moving around the economy. This can help to slow down an overheating economy.

In contrast, during periods of recession, the Bank of Canada may reduce interest rates to stimulate growth. The cost of borrowing money goes down, more people and corporations borrow, there is more money in the system and economic activity accelerates.

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Lesson 2: Financial Markets

Introduction

Welcome to the Financial Markets lesson. In this lesson, you will learn the concept of supply and demand, as well as the importance of financial markets.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the concept of markets and the effects of supply and demand
- explain how supply and demand relates to financial markets
- describe how the financial markets facilitate the transference of capital from suppliers to those who require capital

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Markets

A market is a place where buyers and sellers meet. It can be a physical building or an electronic network. It can be local, national, or international. Markets are often categorized according to the products or services in which they deal. For example, there are labour markets, consumer goods markets, and financial markets. At the heart of each transaction in these markets are two elements: a selling side and a buying side. In economic terms, the selling side is often referred to as the supply side, while the buying side is called the demand side.

The forces of supply and demand in a particular market determine the price at which goods and services will change hands. Just about any situation in economics can be explained in terms of supply and demand.

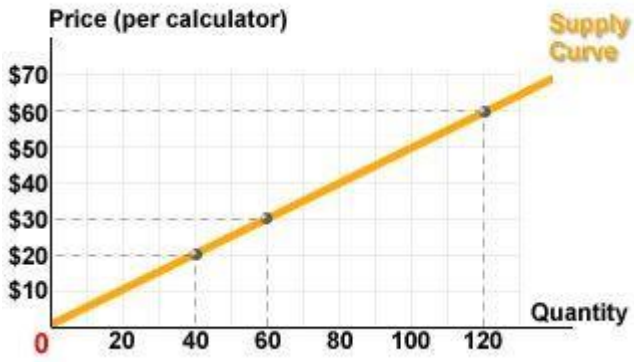
Supply and Demand

At its simplest, the price of any market transaction between a buyer and a seller is determined by supply and demand.

Supply is the quantity of goods or services supplied at a particular price per unit. The quantity increases if sellers can charge a higher price per unit.

Example

A manufacturer may be willing to produce 40 calculators if it can charge $20 per unit; 60 calculators if it can charge $30; and 120 calculators if it can charge $60.



The supply curve indicates the behaviour of sellers. The supply curve slopes upward to the right.

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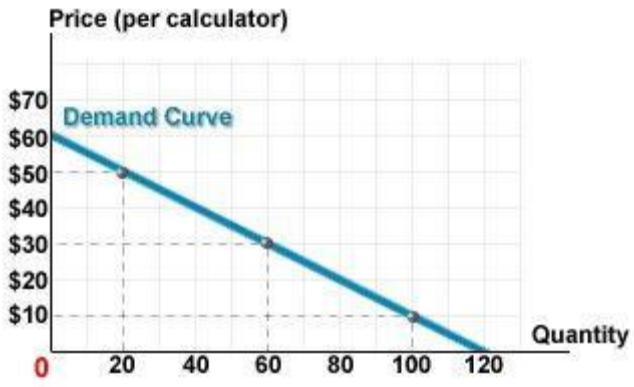


Demand is the quantity of goods or services that buyers want to purchase at a given price per unit. Buyers demand more goods or services if the price decreases.

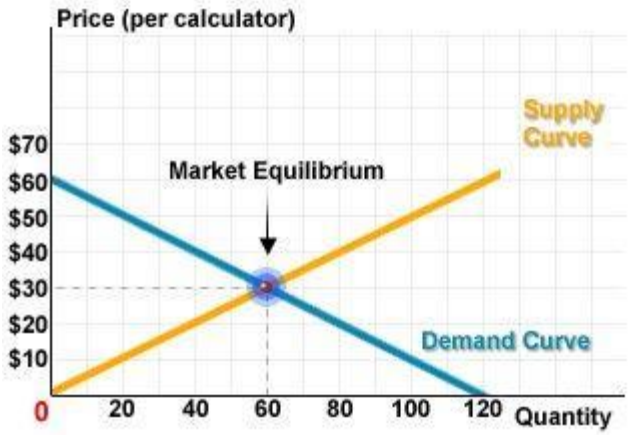
The demand curve slopes downwards to the right because buyers tend to buy more when prices decline.

Example

Consumers are willing to purchase 20 calculators if the price is $50 per unit; 60 calculators if the price is $30; and 100 calculators if they pay only $10.

Market Equilibrium

Market equilibrium is the point where the supply curve and demand curve intersect. You can see from this graph that at a price of $30 consumers are willing to purchase 60 calculators and the producers are willing to sell the same amount. We say that the market for calculators clears at a price of $30.



Financial Markets

A financial market is a market in which financial assets are traded. In financial markets there are suppliers of capital and consumers of capital. Just as in other markets financial market prices reflect supply and demand.

Supply

The supply of capital in the Canadian financial markets comes from the following sources:

- household savings
- retained earnings that corporations have not paid out as dividends
- budget surpluses in the government sector

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- savings from abroad

These sources of supply, commonly referred to as lenders, are willing to lend out capital to some entity with the expectation of profit in return.

Demand

The demand for investment capital comes from the spending decisions of the following:

- governments (federal, provincial, municipal)
- corporations
- Canadian households
- foreigners interested in the Canadian financial markets

These consumers of capital are commonly referred to as borrowers. For example, if a government needs to borrow funds it issues bonds. Investors purchase those bonds and act as lenders to the government.

Supply and Demand in the Financial Markets

Financial markets are subject to the same supply and demand influences as any other market and can be viewed in the same manner. If there is a sudden increase in demand for stocks or bonds, then the cost of those investments rises as the demand curve shifts upwards.

Investment capital has three related characteristics that affect the supply and demand curves in financial markets.

Characteristics	Description
Scarcity	There is a limited supply of investment capital and those seeking capital must therefore compete for it.
Sensitivity	Sensitivity is the degree to which investment capital is influenced by changes in financial markets and the overall economy. With the growing amount of investment options available and the increased ease of access to information about those investments, investors are becoming more discriminating in their investment choices.
Mobility	Improvements in technology have made it possible for capital to move quickly from one part of the world to another. For instance, the foreign exchange markets trade more than $1 trillion every day on a 24 hour a day basis. This mobility has increased efficiency but it also serves to increase financial crises through rapid flow of capital.

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Importance of Financial Markets

Being able to convert idle savings into investment capital is critical for the long-term prosperity of an economy. For example, by lending money to buy new housing, banks help local infrastructures grow and meet the needs of an expanding population. The same is true when governments borrow money to build hospitals and roads or when corporations issue securities to finance expansion of their operations. Without access to investment capital, governments and companies are limited by the amount of capital they can access internally.

Nations with low levels of savings tend to have low rates of investment and low rates of economic growth. Nations with healthy economic growth tend to have well developed financial markets that encourage saving and investing.

Financial markets serve borrowers and lenders in three ways:

- channeling funds from lenders to borrowers
- facilitating the timing of purchases
- providing a mechanism for government policy

Channelling Funds

The movement of investment capital from the suppliers to those with demand may be done directly, but is usually handled indirectly by intermediaries such as banks, trust companies, and investment dealers.

Direct Financing

In the case of direct financing, a borrower deals directly with the lender. For example, if a person needs to borrow $1,000 he or she might approach friends and family members to find someone with $1,000 to lend. This is not efficient.

Indirect Financing

In the case of indirect financing, a borrower does not deal directly with the person who has money to lend. Instead, he or she approaches a financial intermediary who acts as a middleman, bringing many borrowers and lenders together. The most common financial intermediaries are banks. Banks have a large pool of funds from their many depositors (lenders) that they can make available to borrowers.

Facilitating Timing of Purchases

Financial markets enable people to time their spending and saving to fit their lifestyle and circumstances. Through financial markets, households have the opportunity to spend in some years and save in others. For instance, in their younger years people set aside savings and invest part of the income while they are working.

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Later in life when they reach retirement, they begin to draw down from their savings and investments to help finance retirement expenses. Financial markets help facilitate the timing of when they want to save or invest and when they want to withdraw and spend.

Providing a Mechanism for Government Policy

Financial markets can be used as a mechanism to facilitate Federal government policy. For instance, one of the key monetary policies in Canada is inflation control. The Federal government and the Bank of Canada work together to set targets for the country's inflation rate.

If the Canadian economy is perceived to be growing too quickly, it can be interpreted as a sign of inflationary pressure. The Bank of Canada can increase its overnight interest rate.

Financial markets then transmit these changes to the rest of the economy. This rise in the overnight interest rate will result in a rise in longer-term interest rates in Canada. As a consequence, the cost of borrowing increases making it more expensive for borrowers like consumers looking to purchase homes or corporations wanting to invest in new equipment to access capital. In turn, this causes the economy to slow down and eventually eases the inflationary pressure which was the original concern of the Bank of Canada.

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Lesson 3: Canada's Financial System

Introduction

In this lesson, you will learn about key elements of the Canadian financial system. This includes the types of financial markets, how capital is raised, and financial market roles.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the main types of financial markets (capital, money, foreign exchange)
- explain how capital is raised in the primary market
- explain the purpose of the secondary market and the role played by exchanges and security firms

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Capital and Money Markets

The Bank of Canada defines Canada's financial system as "the channel through which savings become investments, and through which money and financial claims are transferred and settled". As a Dealing Representative, you will become a participant in Canada's financial system which includes financial institutions, financial markets, and payment systems.

Types of Financial Markets

There are three main types of financial markets in Canada's financial system:

- capital markets
- money markets
- foreign exchange markets

Capital Market

The capital market is a trading place for financial assets. Capital markets bring together organizations seeking capital, including corporations and governments, with investors and lenders.

The capital market has the following characteristics:

- trades mainly stocks and bonds
- trades derivatives, which base their value on capital market securities
- generally a long-term market (as opposed to the money market, which deals with short-term fixed income instruments)

Money Markets

The money market is a trading place for short-term instruments, typically those with a maturity of less than one year, but sometimes up to three years. Money market instruments are used for raising short-term capital or for investing cash surpluses for a short period of time.

Foreign Exchange Markets

Currencies are traded on the foreign exchange markets between various international and domestic banks and dealers. Foreign exchange trading involves selling one currency and buying a different currency. In a currency market, the price of one currency in terms of another is called the foreign exchange rate.

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Example

If the exchange rate is $1.01 Canadian (Cdn) dollar/U.S. dollar, then $1 U.S. dollar can purchase $1.01 Canadian dollars.

Example

If an American were to purchase a book worth $15.00 Cdn, how much would it cost in U.S. dollars?

$15.00 Cdn / (1.01 Cdn/US) = $14.85 U.S.

The Bank of Canada is also involved in the foreign exchange market. Through Canadian chartered banks and investment dealers, the Bank of Canada buys and sells Canadian and foreign currency in order to regulate the Canadian dollar.

Example

Jane wants to purchase a U.S. Growth Fund denominated in U.S. dollars. Currently, the exchange rate is $1.01 Canadian dollar/U.S. dollar. Jane has $10,000 Canadian to invest.
How much will she be able to purchase in U.S. dollars?

$10,000 Cdn / (1.01 Cdn/US) = $9,900.99 U.S.

After five years, Jane's U.S. Growth Fund is worth $15,750 U.S. She wants to sell the investment and convert it back to Canadian dollars. The exchange rate is $1.01 Canadian dollar to U.S. dollar.
What will Jane receive in Canadian dollars from this redemption?

$15,750 U.S. x $1.01 Canadian/U.S. = $15,907.50 Canadian

Newly Issued Shares

Corporations issue new shares for many reasons such as:

- to go from a private to a public corporation by way of an initial public offering (IPO)
- to raise additional capital for an expansion, research and development, or for an increase in working capital
- to raise funds in a private company for the sale of an owner's share of the business

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A corporation issues new shares in what is called the primary market. To do this, it will usually hire an investment dealer to help bring the shares to market. The dealer is a financial intermediary between the company and the primary market. The issuing company relies on the dealer's distribution channels instead of selling the shares itself to the market.

The Underwriting Process

Underwriting is the process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities.

Primary and Secondary Markets

When investors purchase an issue of new shares, money flows from the investor, through an underwriter, to the corporation that issued those shares. This is the primary market. Once these shares are purchased in the primary market they subsequently trade among investors, changing hands whenever a match can be found between people who want to sell their shares and those who want to buy them. These shares are said to be trading on the secondary market. The original issuing company has no further direct financial interest in the subsequent trading of these shares. The secondary market includes the many organized stock exchanges, as well as the over-the-counter markets.

Stock Exchanges

A stock exchange is established for the purpose of trading shares between members of the exchange and their clients. Members of the exchange are regulated by a strict code of conduct to ensure that markets operate smoothly and investors are treated fairly.

Companies must apply to be listed on an exchange. If accepted, companies must obey its listing requirements, including rules concerning the disclosure of information.

Some of the benefits a company enjoys by listing on an exchange include:

- increased marketability of shares due to greater market exposure
- increased public confidence in the company due to the exchange's disclosure rules
- an active secondary market that can broaden a company's shareholder base

Over-the-Counter (OTC)

The shares of publicly traded companies that are not listed on a stock exchange may still be traded on the over-the-counter market (OTC), sometimes referred to as the unlisted market. Unlisted securities trade in the OTC market through a network of dealers.

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There are many reasons a company might consider the OTC market including:

- unwillingness to abide by the disclosure rules of an exchange
- low volume of trading in its shares
- low investor interest
- inability to meet the requirements to be listed, usually because it is a small company

The OTC market also plays a part in the primary market. Many new stock issues that are underwritten by securities firms are first sold over-the-counter before becoming listed on a stock exchange. Large blocks of outstanding shares offered for sale by a single investor, whether listed on an exchange or not, are sometimes sold in the OTC market. Often a securities firm will underwrite the block itself and offer it for sale in the OTC market in the same manner as a new issue. This process is referred to as secondary distribution.

The disclosure standards for the OTC market are not as stringent as those imposed by an exchange. A corporation whose shares are listed on an exchange is generally not allowed to offer shares in the OTC market, with the exception of secondary distributions.

Secondary Debt Markets

There is a large and active market for bond trading. Except for a few exchange listed debentures, bonds trade in the dealer market or over-the-counter (OTC). In other words, trading is conducted directly between financial institutions.

The Roles of Securities Firms

The trading of securities in the primary and secondary markets is facilitated by a network of securities firms, including securities dealers and stockbrokers.

A securities firm is any company that specializes in the trading of securities by performing one or more of the following functions:

- underwriting new issues and secondary distributions
- stock brokerage
- market research and the provision of investment advice
- portfolio management

A securities firm may be organized as a private corporation or partnership, or it may itself be a publicly traded company.

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Dealers and Brokers

Dealers

When a securities firm underwrites a new issue or a secondary distribution, it purchases the securities from the issuing company or the selling investor at a fixed price, and attempts to sell them in the market at a profit. This is called a bought deal. In this case, the securities firm is referred to as a dealer, which is a company that acts as the principal in a securities transaction, buying and selling for its own account. The securities firm is in the position where if the securities do not sell at the anticipated price, the firm will realize a loss. A securities dealer makes its money by purchasing securities and selling them at a profit, in addition to earning commissions charged on transactions handled by the firm on behalf of clients.

Brokers

In some cases, a securities firm will agree to sell new issues only to the best of its abilities, meaning that it will try to sell as many shares as possible at a stated price, but it does not accept any responsibility if all the shares are not sold. This is called a best effort deal. In this case, the securities firm is acting as a securities broker or an agent on behalf of the issuer. A broker arranges for the purchase or sale of securities, handles the flow of cash and may provide clients with investment advice. A brokerage firm makes its money on the commissions charged on each trade it handles on behalf of clients.

Most securities firms have their own research departments, which are responsible for gathering and analyzing information that will assist both themselves and their clients in making investment decisions. The research department may include people who specialize in the technical and fundamental analyses, as well as analysts who specialize in particular industries such as mining or biotechnology. The information developed by the research department is usually distributed to clients and potential clients free of charge in the hope that the recipient will decide to become a client of the securities firm.

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Summary

Congratulations, you have reached the end of Unit 4: Economic Factors and Financial Markets.

In this unit you covered:

- Lesson 1: Economic Factors
- Lesson 2: Financial Markets
- Lesson 3: Canada's Financial System

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 4 Quiz button.

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Unit 5: Types of Investments

Introduction

As a Dealing Representative, it is essential that you have in-depth knowledge about the different types of investments that are available in the financial markets, so that you can effectively match clients with suitable investments.

In this unit, you will learn about fixed income and money market instruments, equities, and derivatives. You will also learn about how each investment type is used within investment funds.

This unit takes approximately 2 hours to complete.

Lessons in this unit:

- Lesson 1: Building Blocks of Investment Funds
- Lesson 2: Fixed Income Securities
- Lesson 3: Equities
- Lesson 4: Derivatives

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Lesson 1: Building Blocks of Investment Funds

Introduction

Investment funds are collections of different types of investments. The holdings within a given investment fund are intended to achieve one of a number of different investment objectives. As a Dealing Representative, your clients will expect you to have an understanding of the different investment types held within investment funds.

In this lesson you will learn about the general structure of investment funds, and the different investment objectives they are intended to meet.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- describe the concept of an investment fund
- distinguish between the different investment objectives
- describe who issues securities and why

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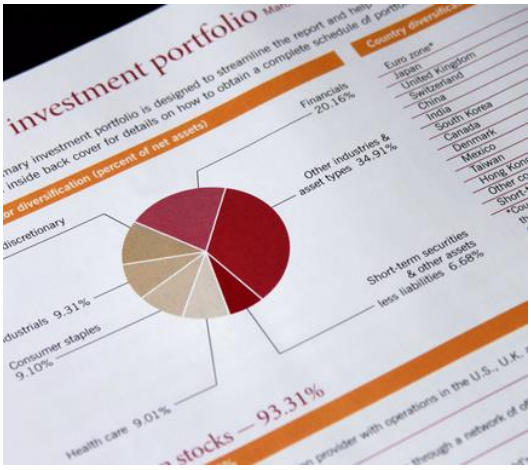
The Building Blocks of Investment Funds

Investment funds are investments that hold a collection of different securities such as equities and bonds. Collectively, the securities in an investment fund are called holdings. A typical investment fund can hold dozens or hundreds of different securities.

The investment goal of an investment fund determines which securities are included in the fund's holdings because each security plays a unique part in helping the fund reach its goal. Therefore, to understand the different categories and types of investment funds, we need to first understand the different securities that form the building blocks of the funds.



Knowledge of the building blocks will help you understand how the underlying securities affect the performance and return of an investment fund. As a Dealing Representative this will help you manage your clients' expectations and recommend suitable investment funds.

Investment Objectives

An investment fund's investment objectives determines the various types of securities that are held in a given fund. There are three main investment objectives:

- Safety of Principal
- Income
- Growth

Safety of Principal

Investment funds that have safety of principal as the investment goal strive to protect investors from losing any of their original investment. In other words, investors expect to get back at a minimum the amount of money they put into the investment.

Example

Bob has $50,000 that he plans to use to purchase a home in one year. Joe, his Dealing Representative, recommends an investment fund that provides safety of principal and some income. This way, Bob will likely get back all the money he put into the fund along with some income.

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Income

Investment funds with a primary investment objective of income provide investors with a regular source of income over the course of their investment time horizon. Income-oriented investments are typically fixed income securities, which are essentially debt issued by corporations or governments and shares that pay dividends. The corporations or governments are the borrowers, and they must make regular payments to the lenders, i.e. the investors.

Compared to investments that offer safety of principal, income investments will experience greater price fluctuations. Depending on the situation, investors may find that their investments have either grown or declined in value compared to their original principal.

Example

Jane, 65, has just retired and needs additional income to meet her cash-flow needs. Ryan, her Dealing Representative, recommends that Jane invest in a fixed income fund that makes monthly distributions to unitholders. Jane's original investment is $35,000 into the fund. Later that year, Jane notices that the value of her investment is now only $34,800. A few months later, Jane notices that the value of her fund has rebounded and is now worth $35,040.

Growth

Securities that provide growth have the potential to appreciate over time. Investors purchase growth investments in the hope that the market price of the securities when they sell their investments will be higher than the original purchase price.

Growth investments typically include equities that represent ownership in a corporation. The value of an investors' shares is tied to the prospects of the corporation. If the corporation is profitable or has the potential to do well, equity investors will benefit. If the corporation does poorly or is perceived to be doing poorly, equity investors will suffer. Therefore, equity investors will experience greater price fluctuations than safety-of-principal or income investors.

Example

Stan has some money available to invest and does not require it until he retires in 30 years. Rinaldo, his Dealing Representative, recommends that Stan invest in a Canadian equity fund. Stan's original investment is $25,000. The value of Stan's portfolio increases and at the end of the year Stan's investment is now worth $26,400. At the end of the following year, there is bad news released about a couple of companies in the equity fund portfolio. This negatively affects Stan’s investment, and the value of his fund drops to $24,000.

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Why Governments and Corporations Issue Securities

Governments and corporations each issue securities as a means of raising capital. These organizations then use the capital to fund expenditures for various purposes.

Governments

From time to time, governments may need to raise money in order to pay for spending commitments such as health care, defense, or deficit financing. Governments can borrow money from the public by issuing fixed income securities such as:

- Short-term instruments including treasury bills and provincial short-term papers
- Medium-term federal and provincial bonds
- Long-term federal and provincial bonds

Corporations

One of the ways corporations can raise money to grow their businesses is to divide ownership into smaller parts and sell those parts to the public in the form of shares. In exchange for a share, a corporation receives the money it needs, and investors have an opportunity to share in the corporation's earnings.

Corporations can issue two types of shares:

- **Common shares**—Share ownership that entitles investors to a portion of the company's earnings and some control of the corporation.
- **Preferred shares**—Share ownership that entitles investors to receive a fixed amount of the company's earnings on an ongoing basis. This type of share ownership typically does not give investors control of the corporation.

If a corporation wants to maintain its current division of ownership, rather than issuing shares, the corporation can borrow from the public and issue fixed income securities such as bonds. This way, the corporation receives money without increasing the number of owners in the corporation.

Corporations can issue fixed income securities such as:

- money market securities such as commercial papers
- medium- and long-term bonds

Corporations can also borrow money from banks and other lenders. However, interest payments on these borrowing arrangements can be very high, which is why some corporations choose to raise funds by issuing either shares or fixed income securities.

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Lesson 2: Fixed Income Securities

Introduction

Fixed income securities are a form of loan where the investors are the lenders and the borrowers are the organizations such as governments or corporations. As a Dealing Representative, it is very important that you are familiar with the different types of fixed income securities and how they are bundled in investment funds to meet various investment objectives.

This lesson takes approximately 1 hour minutes to complete.

At the end of this lesson, you will be able to:

- describe characteristics of fixed income securities
- describe the major features of short-term debt and money market instruments
- describe the features of a bond and how it works
- explain how the bond market works
- list the different types of bonds and explain the differences between them
- explain the inverse relationship between interest rates and bond prices
- differentiate between current yield and yield-to-maturity
- describe what the yield curve illustrates and the main types of yield curves
- discuss the main types of risk associated with investing in bonds
- describe the role of credit rating agencies
- discuss how bonds are used in fixed income funds

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Fixed Income Securities

When governments or corporations need money, they can borrow money from the public by issuing fixed income securities. Fixed income securities are essentially loans provided by investors. The debt security includes a contractual obligation stating that the issuing government or corporation must pay interest and return the principal (i.e. the investment amount) to the investor (i.e. lender) by the maturity date (i.e. the bond's expiry date).

Some key concepts when dealing with fixed income securities are:

Concept	Definition
Term-to-maturity	The term-to-maturity or lifespan refers to the length of time between the current date and the maturity date. Fixed income securities have a finite life and expire on a specified date called the maturity date. On that date, interest payments cease and the principal must be repaid in full to the investor.
Term	Term refers to one of three term-to-maturity durations: • Short-term – mature in less than five years • Medium-term – mature between five and ten years • Long-term – maturities that are more than ten years
Par value	Also referred to as the face value or face amount, this is the value of a fixed income security. It is the amount of the original principal investment, which must be fully repaid to the investor when the security matures. Typically, the par value is denominated in multiples of $1,000 (e.g. $5,000 or $10,000).
Coupon rate	The coupon rate is used to calculate the regular interest payments paid by a bond, which is also referred to as the coupon payment. The coupon rate is fixed throughout the life of the fixed income security.

Short-Term Debt Instruments

Governments and corporations issue short-term debt instruments to fund their short-term expenditures. Typically, short-term debt instruments have two common features:

- the term to maturity is under five years
- the instrument is sold at a discount

The defined term-to-maturity for short-term debt can vary across issuers. Some corporations define short term as a period that is less than two years while others see it as a period under five years.

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Money Market Instruments

Money market instruments are short-term debt that typically have a maturity of under a year. The short maturity makes money market instruments very liquid, which means they can be converted into cash very quickly and easily. The price of money market instruments do not fluctuate a great deal, which makes them a relatively stable and safe investment.

Money market instruments meet the investment objectives of safety of principal and stable income. They are also very low-risk investments. Money market instruments include:

- treasury bills
- provincial and municipal short-term papers
- commercial papers

Treasury Bills

Treasury bills (T-Bills) are short-term debt instruments issued by the Canadian government to finance their short-term cash needs. T-Bills do not pay periodic interest to investors. Instead, T-Bills are sold at a discount, and then at maturity the government pays the investor the face value. The difference between the face value and the price the investor paid for the T-Bill is interest income.

For T-Bills, the investment objectives are safety of principal and income. T-Bills are very low-risk investments since they are guaranteed by the Government of Canada.

Example

Gary bought a 120-day T-Bill with a face value of $10,000, for $9,950. When the T-Bill matures after 120 days, the government will pay Gary $10,000, the face value.

The difference between the face value and the purchase price is $50, which is interest income calculated as follows: $10,000 - $9,950.

T-Bills in the Primary Market

The Bank of Canada issues T-Bills on behalf of the Government of Canada. The Bank of Canada conducts an auction on a two-week cycle where T-Bills are sold in large denominations to banks and investment dealers. The terms to maturity offered at the auction are 98, 182, and 364 days.

T-Bills in the Secondary Market

There is a secondary market run by investment dealers where individuals and institutions can buy and sell T-Bills. In the secondary market, T-Bill prices change in relation to interest rates. When rates increase, T-Bill

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prices decrease. Conversely, when interest rates decrease, T-Bill prices increase. If investors sell their T-Bills for a higher price than the original purchase cost, they will make a profit. This form of income, from a sale that incurs a profit, is called a capital gain. If investors sell their T-Bills for a lower price than the original purchase cost, they will lose money. This form of income loss from a sale is called a capital loss.

Example

Monica buys a 6-month T-Bill for $9,850, which will mature at a face value of $10,000. After three months, the interest rate drops and the current market price of Monica's T-Bill rises to $9,950. Monica sells her T-Bill in the secondary market for $9,950 and realizes interest earned of $75 and a capital gain of $25. The interest earned is calculated as [($10,000 -$9,850) x 3 months/6 months]. The capital gain is calculated as ($9,950 - $9,850 -$75).

On the other hand, if interest rates increase and the current market price of her T-Bill after 3 months falls to $9,800, if she sells her T-Bill she would realize interest earned of $75 and a capital loss of $125, calculated as ($9,800 - $9,850-$75).

T-Bill Return Calculation

In order to determine the rate of return for a T-Bill, you must calculate the quoted yield. The quoted yield is expressed as a percentage. The formula is as follows:

Quoted Yield = {[(Face value – Price) ÷ Price] x (365 ÷ Term to Maturity)} x 100

Example

Sue purchased a 91-day T-Bill with a face value of $1,000, for $990.13. Using the quoted yield formula, we can calculate the rate of return on her T-Bill as follows:

[(((1,000 – 990.13) ÷ 990.13)) x (365 ÷ 91)] x 100 = 4%

The rate of return on her investment is 4%.

Provincial and Municipal Short-Term Papers

Provincial and municipal short-term papers are debt securities issued by the provincial or municipal government to raise money to pay for capital spending. Similar to T-Bills, these instruments are sold at a discount and pay the face value at maturity.

The investment objective of short-term papers is safety of principal and income. Provincial and municipal short-term papers offer slightly higher interest income than T-Bills, but the risk level is also higher.

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Example

The town of Milton, a municipality, wants to raise $10,000,000 for improvements to the sewer system. The town hires an investment dealer to underwrite and sell their debt securities. The investment dealer establishes an interest rate based on the credit rating of the municipality, and then sells the securities to investors.

Commercial Papers

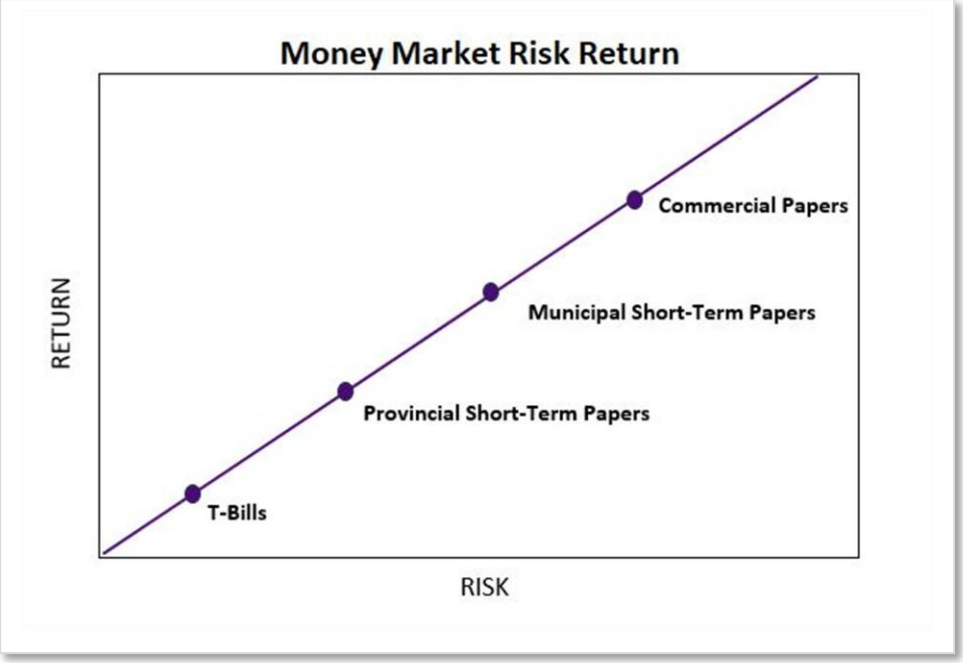
Commercial papers (CPs) are issued by corporations seeking to get short-term loans to fund short-term cash shortages. Similar to other money market instruments, CPs are purchased at a discount, and at maturity the issuer pays the face value to the investor. The difference between the face value and purchase price is interest income.

CPs typically pay higher rates and are considered higher risk than T-Bills because they are not guaranteed by the government or a commercial bank. Instead, the issuing corporation borrows money under its own name and credit rating. The interest rate will depend on how stable the corporation is, and the likelihood of it repaying the loan.

The investment objectives are safety of principal and income.

Risks and Returns of Money Market Investments

Each type of money market investment has a different level of risk and corresponding level of return. Generally, investments with higher levels of risk compensate investors with the potential for higher return.



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Money Market Instruments and Investment Funds

Portfolio managers use money market instruments in their investment fund portfolios either to meet their primary objective of safety of capital, like in a money market fund, or as a short-term placeholder for cash. Quite often referred to as cash equivalents, money market instruments provide a relatively safe and flexible alternative to cash. Portfolio managers require this flexibility to meet redemption requests or to park cash while they are making decisions for longer term investments.

Bonds

Bonds are fixed income securities with a maturity of greater than one year. Newly issued bonds typically sell at their par value. Bond issuers promise to pay regular coupon payments to the investor, also referred to as the bondholder. Bonds have a finite life which means they mature on a pre-determined date.

The investment objectives of bonds are regular income and stability of principal.

The risk and return of bonds varies based on a number of factors, including the credit worthiness of the issuer, among other considerations. Bonds issued by corporations with good credit ratings typically involve lower risk. On the other hand, corporations with poor credit ratings involve higher risk and as such, pay higher coupon rates to attract investors and to compensate them for the higher risk.

5 ¼ % Repayable 15th November 2024
Government of Canada
Treasury Bond
$1,000
5 ¼%
$1,000
This bond entitles the bearer to the payment of one thousand dollars, together with the interest thereon at the rate of five and one quarter percent per annum. Principal is repayable on the fifteenth day of November two thousand twenty four.
Dated this 14th day of February 2014.
2024
Secretary to the Treasury

Term	Definition
Issuer (Government of Canada Treasury Bond)	This is the borrower. The issuer is either a government body or corporation. The issuer is responsible for all the coupon payments and repayment of principal.

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Term	Definition
Coupon Rate (5.25%)	The coupon rate is the rate of interest that will be paid to the bondholder. It is a nominal annual interest rate and is expressed as a percentage of the par value. The coupon payment is the interest payment calculated using the coupon rate and the par value. Although the coupon rate is expressed as an annual percentage, most bonds pay interest semi-annually.
Par Value ($1,000)	Also known as face value, face amount or principal, this is the amount that was originally lent to the issuer and is to be repaid at maturity. Par value is usually denominated in multiples of $1,000.
Maturity Date (the fifteenth day of November two thousand twenty four)	This is the date the bond will expire, at which point the last coupon payment is made and the principal is repaid to the bondholder. When bonds are issued, the maturity date is usually the same day (e.g. May 9) but in a future year. Coupon payments are paid on the anniversary of this day and the semi-annual anniversary day (e.g. May 9 and November 9).

The Bond Market

When government or corporations want to raise money through a new bond issue, they hire an investment dealer to help them with the process. This first step where the money raised from investors goes directly to the issuer is known as the primary distribution.

Bond prices are quoted in relation to $100. When a bond price is $100, it is referred to as par. Typically primary distributions of bonds are priced at par.

Example

Rakesh purchases $10,000 par value of a 5-year Government of Canada bond. Because it is a new issue, the price of the bond is $100. Rakesh pays $10,000 for his bond, calculated as (($100 ÷ $100) x $10,000).

After the primary distribution, investors can sell their bonds to other investors in the bond market. Unlike the stock market, which has a central place to trade stocks such as the Toronto Stock Exchange (TSX), the bond market does not have a central trading place. Instead, the majority of bonds trade in the over-the-counter market, a computerized network where investment dealers transact directly with each other. A small number of bonds do trade on an exchange.

In the bond market, the price of a bond can change from par due to several factors such as interest rate changes. Bonds that are priced above par are said to be trading at a premium, while bonds that are priced below par are said to be trading at a discount.

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Example

If in the bond market, Rakesh's bond is discounted to a price of $99, then he would have to accept $9,900 if he wants to sell his bond, calculated as (($99 ÷ $100) x $10,000). In this situation, Rakesh incurs a capital loss. If his bond is trading at a premium of $101, then he would receive $10,100 if he sells it, calculated as ($101 ÷ $100) x $10,000). Here, Rakesh incurs a capital gain.

Globally, the bond market is significantly larger than the stock market, since this type of security is very important in maintaining well-functioning governments and corporations.

Types of Bonds

There are two classes of bonds:

- coupon bonds – provide regular coupon payments to investors
- zero-coupon bonds – make a lump sum payment to investors upon maturity (also called strip bonds)

Coupon Bonds

Historically, bondholders were given a bond certificate showing they loaned money to the issuer. Attached to each certificate were a number of coupons which entitled the bondholder to receive regular coupon payments. When it was time to receive a coupon payment, the bondholder would cut out the coupon from the bond certificate and redeem it at the bank.

With coupon bonds there is a built-in contract that states the issuer's legal obligation to provide coupon payments, usually semi-annually or annually, and return of principal. If the issuer defaults on the coupon payments or principal, the bondholder can force the issuer into bankruptcy to sell their assets and use the proceeds to repay the bondholders.

While bondholders no longer receive physical certificates, coupon bonds are still obligated to make regular coupon payments. At maturity, the issuer must make one final coupon payment and return the bondholder's principal. The coupon payments for coupon bonds are calculated as follows:

Coupon Payment = [(face value x coupon rate) ÷ number of payments per year]

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Example

Karen invests $10,000 in a new 3-year ABC bond issued on February 1, Year 1. The coupon rate of ABC bond is 6% and the coupon payments are made semi-annually. Karen's coupon payment is $300, calculated as [($10,000 x 6%) ÷ 2]. The following illustrates Karen's payment schedule.

Date	Payment	Type of Payment
August 1, Year 1	$300	Interest
February 1, Year 2	$300	Interest
August 1, Year 2	$300	Interest
February 1, Year 3	$300	Interest
August 1, Year 3	$300	Interest
February 1, Year 4	$300	Interest
February 1, Year 4	$10,000	Principal

Investment Profile of Coupon Bonds

The investment objective of coupon bonds is stability of income, with a higher level of return than money market instruments. The expected return for coupon bonds is both income and the potential for an additional return in the form of capital gains due to changes in interest rates, if the coupon bonds are traded on the secondary market. The risk level of coupon bonds ranges from low to medium. Regular coupon payments, and the promise to repay the principal, give these bonds a stable quality. However, their price sensitivity to interest rate changes increases the risk level.

Debentures

Debentures operate the same way as bonds, but they differ by how they are secured. Bonds are secured by specific assets of the issuer such as property, inventories, equipment, or other securities. Debentures are not secured by real assets or collateral. Instead, they are backed by the reputation and credit worthiness of the issuer.

Investment Profile of Debentures

Debentures offer a higher level of income than regular secured bonds. Debentures are considered medium risk because they are not secured by any real assets, and they have lower priority than bondholders for the company’s assets in the event that the company goes bankrupt.

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Convertible Bonds

Convertible bonds are a type of coupon bond that offer investors the option to convert the bonds into common shares, which confer ownership interest in the company issuing the bonds. This option is at a pre-set price, within a specified time frame. In exchange for the conversion option, the bond issuer usually offers a lower coupon rate than that offered with other bond types.

Example

Cheryl is considering investing in common shares of BIZ Corporation, but she is uncertain about how well the company will perform in the future. She buys a BIZ convertible bond, which offers her the option to convert her bond into common shares at $40 per share at a specific date in the future.

If BIZ common shares rise in value to $45 per share, Cheryl can make the conversion within the allowable time and convert her bond into common shares at the lower price of $40. However, if the common share price falls to $30, she does not have to convert her bond. She can continue to hold the bond and collect the coupon payments until the bond matures.

Investment Profile of Convertible Bonds

Convertible bonds appeal to investors who want the stability offered by bonds and the option to own common shares. Compared to regular bonds, convertible bonds are higher risk because they have lower priority for the issuer’s assets in the event of bankruptcy.

Bonds with Additional Features

Coupon bonds can also have additional features that may be triggered either at the issuer's option or the bondholder's option.

Callable or Redeemable Bonds

With a callable bond, the issuer (borrower) reserves the right to buy back, or call, the bond from the bondholder within a specified time period and at a specified price, usually at a premium to face value. This makes sense if interest rates drop and the borrower can issue bonds at a lower interest rate. Investors demand a higher rate of interest on callable bonds because they may have to sell the bond back at a disadvantageous time.

Extendible Bonds

If a bond has an extendible feature, it allows the investor to extend the term of the bond within specified limits. This is an attractive feature if the bond is close to maturity, and is paying higher interest than current rates. Investors accept a lower rate of interest to obtain this feature.

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Retractable Bonds

These bonds allow the bondholder to redeem a bond at par before the maturity date. A bondholder may choose to redeem early if the coupon rate is lower than current interest rates, and invest the proceeds elsewhere.

Zero-Coupon Bonds

Zero-coupon bonds, also called strip bonds do not provide coupon payments. These bonds are sold at a discount and redeemed at maturity for their face value. The interest income constitutes the difference between the face value of the zero-coupon bond, and purchase price.

Example

Jean buys a zero-coupon bond for $9,500 that will mature in 3 years with a face value of $10,000. With this zero-coupon bond Jean will earn interest income of $500, over a period of 3 years, calculated as $10,000 - $9,500.

Zero-coupon bonds are created when an investment dealer takes a regular coupon bond and strips its coupon payments. In doing so, the investment dealer creates separate bonds for each coupon payment and the principal.

Zero-Coupon Bonds Characteristics

With zero-coupon bonds, the face value at maturity is pre-determined so investors know exactly how much interest income they will receive. Zero-coupon bonds are typically held in registered accounts such as Registered Retirement Savings Plans (RRSPs). Interest income generated by securities is taxed annually. Although strip bonds do not pay interest annually, the interest accrues, or builds up, each year. Subsequently, investors are required to pay taxes on the accrued annual interest income even though they do not receive any interest income until the bond matures.

By putting strip bonds in a registered account where interest income is sheltered, investors are not required to calculate the annual accrued interest income or pay taxes on this amount. If a strip bond is held in a non-registered account, investors are required to pay taxes each year on the accrued interest income, which is interest that accumulates but has not been paid.

Investment Profile of Zero-Coupon Bonds

The investment objectives of zero-coupon bonds are income and stability of principal (if held to maturity). Income is derived from interest, as well as the potential for capital gains if the zero-coupon bonds are sold before maturity in the secondary market.

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Zero-coupon bonds have a higher risk than coupon bonds because no payments are received until the bonds mature. Generally, payments received sooner are considered to be safer than payments received at a later time because there is greater uncertainty in the future. For example, the issuer can go bankrupt or interest rates may rise.

Mortgage Bonds

Mortgage bonds are fixed income securities that invest in a pool of mortgages. These bonds offer bondholders regular interest income and safety of principal. Canada Mortgage Bonds (CMBs) are invested in a pool of mortgage-backed securities, which are a collection of mortgages that are packaged into a security and sold to investors. CMB holders are paid the interest and principal from the mortgage-backed securities.

CMBs are guaranteed by the Canada Mortgage and Housing Corporation (CMHC), a government-owned home insurance provider. They are also backed by the Government of Canada.

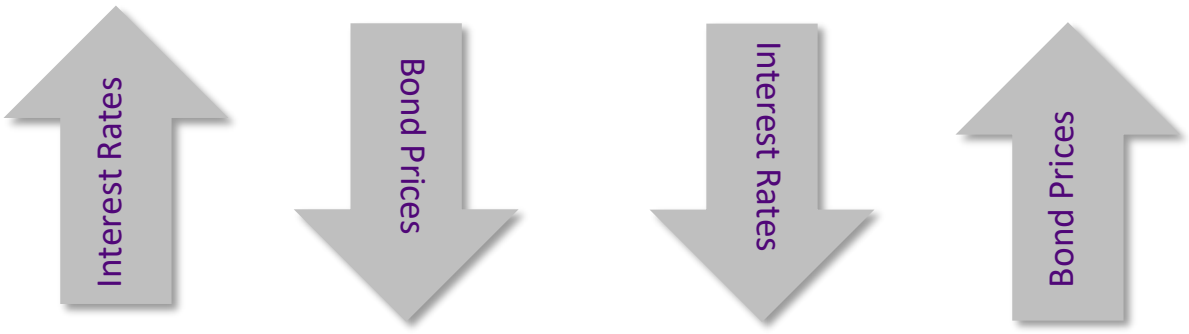
Investment Profile of Mortgage Bonds

The investment objectives of mortgage bonds are stable income, and safety of principal (if held to maturity). Income is derived from interest, as well as the potential for capital gains if the mortgage bonds are sold before maturity in the secondary market.

Mortgage bonds are considered to be low risk because they are backed by real assets (buildings and houses) that can be sold to repay the bondholders. In the case of CMBs they are backed by CMHC and the government of Canada.

Bond Prices and Interest Rates

The relationship between interest rates and bond prices is important for bonds that trade on the secondary market. That is, the bonds have not matured and bondholder wants to sell them. Since the terms of an existing bond, such as the coupon rate and maturity date are fixed, the only component that can be adjusted is the price. Therefore, bondholders will be subject to the current market conditions, in this case interest rates, when they sell their bonds.



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There is an inverse relationship between bond prices and interest rates. What that means is, when prevailing interest rates rise, the price of existing bonds generally falls. Conversely, when prevailing interest rates fall, bond prices generally rise.

When prevailing interest rates rise, the price of existing bonds generally falls.

Example

Bonds are issued with a fixed coupon rate. Last year, Yolanda purchased a 10,000 VTM 7% 11/11/28 bond with a coupon rate of 7%. She will receive a coupon payment of $700 a year, calculated as ($10,000 x 7%).

This year, interest rates have increased to 8%. Dominic bought a 10,000 HFN 8% 12/12/29 bond with a coupon rate of 8%, which means that he will receive $800 a year, calculated as ($10,000 x 8%).

Because the HFN bond pays a higher coupon rate (8%) than the VTM bond (7%), the HFN bond is more attractive, and a rational investor would choose to buy the HFN bond with a higher coupon payment.

Therefore, the seller of the VTM bond must reduce the price to attract investors, since the coupon rate is fixed and cannot be changed.

Conversely, when prevailing interest rates fall, bond prices generally rise.

Example

Last year, Marta purchased a 10,000 OWS 7% 03/01/33 bond with a coupon rate of 7%. This year, the prevailing interest rate dropped to 6%. Liam purchases a 10,000 INQ 6% 05/01/34 bond with a coupon rate of 6%. He will only receive a coupon payment of $600 per year. Since the OWS bond is now a more attractive investment at 7%, the increased demand will raise the price of the OWS bond in the secondary market.

Bond Return Calculations

As a Dealing Representative, it is very important that you understand how the return on investment for bonds is calculated. Two common calculations to determine the return or yield of a bond are: current yield and yield-to-maturity.

Current Yield

The current yield formula calculates the potential return on investment for bondholders, based on the current market price of the bond and the stated coupon payment. The current yield formula is:

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Current Yield = (Coupon Payment ÷ Market Price) x 100

Example

Luther purchases a bond with a par value of $1,000 and a coupon rate of 6%. He pays $980 for the bond, which is the market price. The coupon payment is $60, calculated as (6% x $1,000). The current yield of Luther's bond is 6.12%, calculated as (($60 ÷ $980) x 100).

Yield-to-Maturity

A limitation of the current yield formula is that it provides only the annual yield, and does not calculate the overall return from the reinvestment of interest, called compounding. It also does not take into account any capital gains or capital losses resulting from a discount or premium on the bond price. Since the current yield is based on the current market price of bonds, the yield may change from year to year, when the market price of a bond changes.

The yield-to-maturity (YTM) is the annual return an investor earns if the bond is held to maturity. This return is considered a more accurate measure of a bond's return than the current yield, because it factors in the coupon and principal payments, the timing of the payments, the bond's price and the time to maturity. Unlike the current yield, it assumes all coupons are reinvested at the same rate.

The YTM calculation is complex. Bond tables, calculators, and computer programs have been developed to determine the YTM of a bond. For this course you are not required to calculate the YTM.

Bond Prices, Interest Rates, and Yields

The reason it is important to understand the inverse relationship between bond prices and interest rates is because these factors affect bond yield, or return. Before delving more deeply into how bond prices and interest rates affect yield, it is essential to understand two characteristics of a rational bond investor. All things being equal:

- Bond investors prefer higher coupon payments.
- Bond investors tend to invest in bonds primarily for the steady coupon payments. Therefore, bond investors will be attracted to bonds that pay higher coupon payments.
- Bond investors prefer lower purchase prices.
- Like any rational investors, bondholders do not want to pay high prices for a bond.

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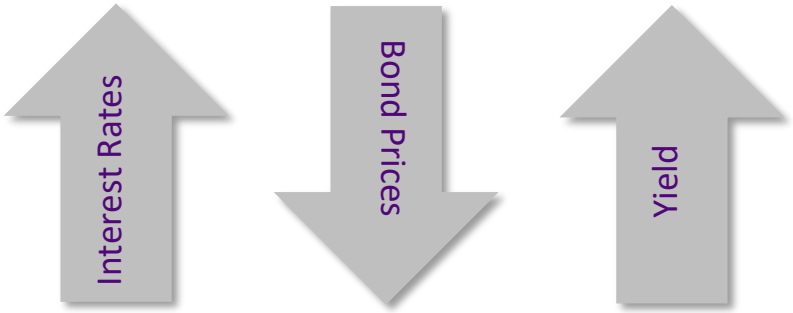
When Bond Prices Fall, the Yield Rises

Remember the bond's coupon rate and coupon payments are fixed. When interest rates increase, prices of existing bonds decrease. As a result, investors shopping for bonds can buy the bond at a lower price and receive the same coupon payments as those who purchased the bonds at par.

An investor who paid less than par is said to have purchased their bond at a discount. Bonds that are purchased at a discount have a higher yield than the coupon rate.

The relationship between bond prices, interest rates and yield looks like this:



Example

James bought a bond at a par value of $1,000 with a coupon rate of 10%, which means that James gets a coupon payment of $100 each year, calculated as ($1,000 x 10%).

A year later, interest rates rise and the market value of James's bond falls to $800. James sells his bond to Margaret for $800. At a price of $800, Margaret is able to get the same $100 yearly coupon payment at a lower market price, a discount price. Margaret's yield is 12.5%, which is higher than the return James got on the bond.

James's current yield is 10%, calculated as (($100 ÷ $1,000) x 100).

Margaret's current yield is 12.5%, calculated as (($100 ÷ $800) x 100).

Interest rates have increased and the bond price has decreased, therefore the bond yield has increased.

When Bond Prices Rise, the Yield Falls

Now let's see what happens to the bond's yield when bond prices go up.

When interest rates decrease, they cause the price of existing bonds to increase. As a result, investors shopping for bonds will pay more for existing bonds because they pay a higher coupon payment than newly issued bonds. This will raise the market price of existing bonds.

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An investor who paid more than par value for a bond is said to have purchased their bond at a premium. Bonds that are purchased at a premium have a lower yield than the coupon rate.

The relationship between bond prices, interest rates and yield looks like this:

Example

James bought a bond at a par value of $1,000 with a coupon rate of 10%, which means that James gets a coupon payment of $100 each year, calculated at ($1,000 x 10%).

A year later, interest rates fall and the market value of James's bond rises to $1,200. James sells his bond to Margaret for $1,200. At a price of $1,200, Margaret gets the same $100 yearly coupon payment, but at a higher market price. Margaret's yield is 8.33%, which is lower than the return that James got on the bond.

James's current yield is 10%, calculated as (($100 ÷ $1,000) x 100).

Margaret's current yield is 8.33%, calculated as (($100 ÷ $1,200) x 100).

Relationship Between Bond Prices and Interest Rates

The chart below summarizes the inverse relationship between bond prices and interest rates:

Direction of Interest Rates	Bond Price	Current Yield
Stable or no change	$100 or trading at "par"	Current Yield equal to Coupon Rate
Increase	trading at a "discount", less than par value	Current Yield greater than Coupon Rate
Decrease	trading at a "premium", greater than par value	Current Yield less than Coupon Rate

Yield Curves

The yield curve is a graph that shows the relationship between the yield-to-maturities of the same class of bonds with different maturities. Bonds within the same class are those that have the same credit quality.

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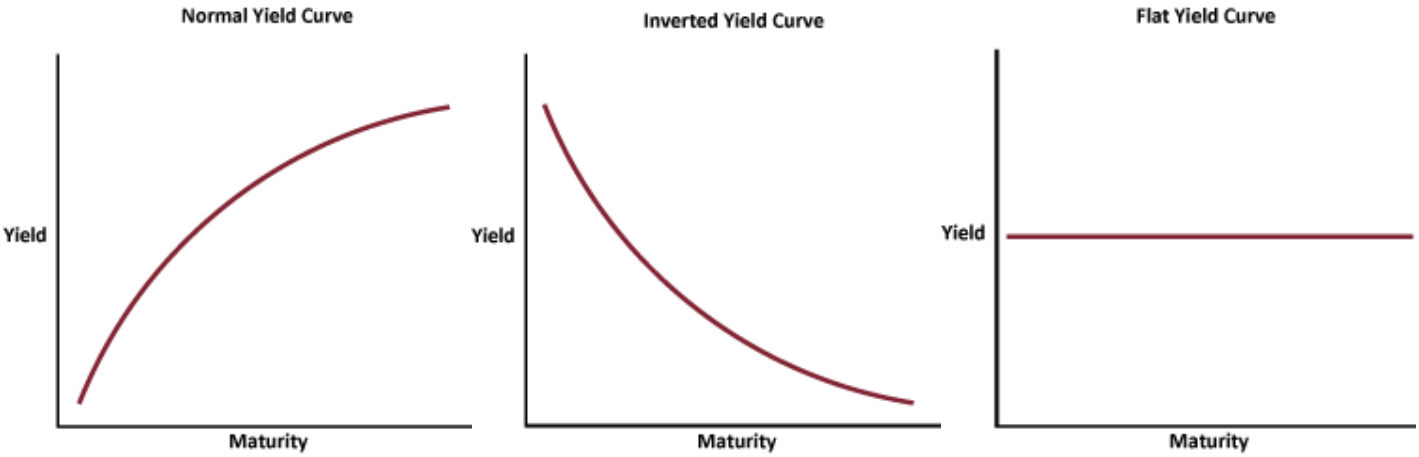
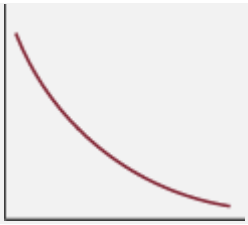
Yield curves are an important tool in fixed income investing and it is often used in forecasting the direction of interest rates and bond pricing.

To get a better understanding of yield curves, we'll look at the three types of yield curves:



Yield Curves Types

Yield Curve Type	Example	Description
Normal Yield Curve		Upward sloping curve shows that longer term bonds have higher yields than shorter term bonds due to the higher risk of long-term bonds. The higher yield reflects investors' expectation that rates will rise in the future.
Inverted Yield Curve		This downward sloping curve shows yield on short-term bonds to be higher than long-term bonds that suggests that investors expect rates to decline. This can be a sign that a recession is forthcoming.
Flat Yield Curve		A flat yield curve shows that short and long-term bonds are receiving almost the same return. It usually indicates the market is in transition trying to determine the direction of interest rates. When the curve moves from normal to flat this can signal an economic slowdown.

Portfolio managers will use the shape of the yield curve to develop a bond investing strategy. They can refer to it to select the term to maturity of bonds that will provide the optimal yield.

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Risks of Investing in Bonds

There are six main types of risk associated with investing in bonds:

- inflation risk
- interest rate risk
- reinvestment risk
- liquidity risk
- sovereign risk
- default risk

Inflation Risk

Also known as purchasing power risk, inflation risk arises when the return of a bond does not keep up with the inflation rate, representing the increase in the costs of goods and services. The inflation rate reduces the actual rate of return of the bond. As a result, the purchasing power of the bondholder's coupon payments is eroded. The dollar value of the coupon payments will buy fewer goods because general prices have gone up.

Example

Clive purchases a bond with a coupon rate of 5%, but the inflation rate is 3%. Therefore, Clive's purchasing power has only increased by approximately 2%, not 5%. Given the inflation rate, Clive's real rate of return, also called the actual return, is approximately 2%.

Interest Rate Risk

This is the risk that the price of existing bonds will decline due to a rise in interest rates. Recall that as interest rates rise the price of existing bonds declines, and when interest rates fall bond prices go up.

Reinvestment, Liquidity, Sovereign, and Default Risk

Reinvestment Risk

This is the risk that coupon payments from a bond will be reinvested at a lower interest rate than the rate on the original investment.

Example

Bonnie purchased a 10-year bond with a coupon rate of 5%. After two years, the prevailing interest rate fell to 3%. Subsequently, Bonnie's coupon payment can only be reinvested at 3% and not 5%.

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Liquidity Risk

This is the risk that a bond investor cannot find a buyer for their bond when he or she wants to sell it. This is often the case in thin bond markets, where demand for bonds may be low due to economic uncertainty.

Sovereign Risk

This is the risk that a government, or an agency backed by the government, may be unable to make interest payments or return the investor's principal amount. The government may be unable to pay due to unfavourable economic conditions.

Default Risk

Also referred to as credit risk, this is the risk that the bond's issuer may run into financial problems and will not be able pay bondholders their scheduled coupon payments. In a worst-case scenario, their principal will not be re-paid. However, in the event the issuer defaults on coupon payments, the investor may still be able to recover some of their investment.

Role of Credit Rating Agencies

Credit rating agencies rate the credit quality of bond issuers. These companies use their professional judgment and other analytical tools to create a series of ratings on corporate and government bond issues.
Investors will refer to the rating assigned to a bond issuer to gauge its default risk.
In Canada, credit rating agencies must apply to securities regulators to become a designated rating organization. They are required to abide by the rules regarding conflicts of interest, proper compliance and reporting requirements.

The Standard & Poor's Rating Services is one of the major global credit rating agencies. According to its rating system, bonds can range from the highest quality, rated AAA, to the lowest quality, rated D. Investment grade bonds, those that have low risk of default, range from between AAA to BBB-. Conversely, high yield bonds (i.e. high-risk bonds) usually have a rating of BB or lower and are commonly referred to as "junk bonds".

Bonds and Fixed Income Funds

Since there is a contractual obligation from issuers to pay regular coupon payments, bonds are usually used in fixed income fund portfolios to provide an income stream that can be distributed to investors. Furthermore, issuers must repay the principal amount; this offers fixed income fund portfolios some stability. Because of this fact, portfolio managers may invest a portion of their portfolio in bonds to lower the overall risk of their fund.

Portfolio managers do need to consider the credit quality of the issuer and the term of the bond since these factors affect the level of risk of the bond. Depending on the investment objective of the investment fund, portfolio managers will select bonds accordingly.

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Lesson 3: Equities

Introduction

Equities are shares of a corporation that investors can buy as part of their portfolio. Equities provide investors with partial ownership in a corporation, which entitles investors to the corporation's net assets and profits, but also exposes them to any risks or losses incurred by the corporation.

In this lesson you will learn about the different types of shares that companies can issue. You will also learn about the risks and potential returns of equity investments, and about how investment funds use equities in their portfolios.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the concept of share ownership
- differentiate between common and preferred shares
- discuss the investment profiles of common and preferred shares
- describe the different types of preferred shares
- explain how investment funds use equities

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Equities

All corporations need money to start up or to grow their business. One of the ways corporations can raise money is to divide their ownership into smaller units and sell the units to the public. Each unit of a company is called a share or equity because it represents an ownership share in the corporation, which entitles investors to the corporation's net assets and profits. But as part-owners, investors will also be affected by any risks and losses experienced by the corporation.

A company's shares are first made available through an initial public offering (IPO). A company will hire an investment dealer to help them bring their shares to market. After the IPO, shares are traded in a secondary market through a centralized exchange such as the Toronto Stock Exchange (TSX). Investors who purchase the shares become shareholders of the company, and as such gain a proportionate ownership of the company according to the number of shares they hold. As shareholders, they are entitled to certain rights and benefits.

Common and Preferred Shares

When corporations issue shares, they fall into two general types: common shares and preferred shares. Both types of shares represent ownership in the corporation that entitles investors to the corporation's earnings and assets. However, common and preferred shares have different entitlements and rights.

Common Shares

Common shares entitle shareholders to a share of a corporation's profit and net asset value, as well as a share in the control of the corporation through voting rights on certain matters regarding the company's operations. Some of the matters on which shareholders are entitled to vote include electing the members of the Board of Directors, the people chosen to control the activities of the corporation. Common shareholders are typically given one vote per share.

The price of common shares reflects expectations of a company's future profitability, and the demand for the shares. Shareholders benefit from common shares that appreciate in price and can realize a capital gain when the shares are sold. However, share prices can also fall and incur capital losses if share are sold.

Investors purchase common shares with the anticipation that they will get a return in the form of capital gains.

Preferred Shares

Preferred shares are considered a hybrid of equity and fixed income securities. Like bonds, they are issued at par value, e.g. $25, and typically provide a regular income stream.

Common and Preferred Shares Entitlements

Preferred shareholders are entitled to receive a portion of the corporation's profits in the form of dividends. The dividends are typically fixed and paid regularly. However, a company has no contractual obligation to pay

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dividends. If dividends are paid, preferred shareholders will receive their dividends before common shareholders.

Preferred shares are considered to be lower risk than common shares because preferred shareholders rank before common shareholders for the company's assets in the event of bankruptcy.

In exchange for the priority they have over common shareholders, preferred shares typically do not come with voting rights. Therefore, preferred shareholders do not have control over the corporation.

The table below highlights the characteristics of common and preferred shares.

Entitlement	Common Shares	Preferred Shares
Dividends	Yes. The amount and frequency will depend on the company's earnings and what the Board of Directors decides.	Yes. Preferred shareholders have priority over common shareholders for dividends. Dividend amount is fixed and frequency of payment is consistent.
Voting Rights	Yes.	No. Some preferred shares will have special voting rights, but the votes will be more restrictive than those of common shares (i.e. can only vote on specific items).
Claim on corporation's assets if the company goes bankrupt	Yes. But common shareholders are last in line for the corporation's assets. They are paid after preferred shareholders.	Yes. Preferred shareholders are paid before common shareholders.

Benefits and Risks of Common Shares

Benefits

Compared with other investment assets such as bonds, common shares produce higher average long-term returns. If the common shares are from a profitable corporation, the price of the common share can appreciate over time. Eventually, shareholders may sell the common shares for a higher price than the purchase price and realize a profit.

Risks

As common shareholders are part-owners of the corporation, whatever affects the corporation's earnings will eventually have an impact on the shareholders. If a business is not doing well for any number of reasons such as poor management decisions, slow economic growth, or competitor products, dividend payments may be

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reduced or cut. Shareholders also face the risk that a company may go bankrupt, in which case they may also lose some or all of their investment money. However, shareholders are not liable for the debts incurred by a company, nor are they personally liable for any actions undertaken by the corporation.

Prices of common shares reflect the company's profitability as well as investors' demand for the shares. Common shares involve more risk than preferred shares because of their price volatility and the uncertainty of the future share price.

Example

Shi-woo purchases 400 shares of Treatwell Medical Devices Inc. at a price of $40 per share. Her original investment is $16,000, calculated as (400 x $40). The company announces that it has plans to aggressively expand into Asia where there are enormous opportunities. The share price rises to $55 based on this news and Shi-woo's investment is now worth $22,000, calculated as (400 x $55). A few months later, the expansion plan stalls because Treatwell is unable to obtain the necessary regulatory approvals to operate in the target countries. The share price falls to $26 and Shi-woo's investment drops to $10,400, calculated as (400 x $26). The following year, the company begins to experience financial difficulty as a result of an economic slowdown and their failure to move into the Asian market. By the end of the year, Treatwell files for bankruptcy. Shi-woo has lost her entire investment of $16,000.

Benefits and Risks of Preferred Shares

Benefits

Since preferred shares can be redeemed back to the issuer for par value, they usually trade around that price. This offers relative price stability. They also provide fixed dividends on an on-going basis.

Risks

Similar to common shareholders, preferred shareholders are affected by the performance of the corporation. If a company performs badly, it may miss dividend payments. Preferred shareholders are also subject to loss of their original investment if the company declares bankruptcy.

Preferred shares are typically redeemable. The issuer may exercise its right to call the preferred share at an inopportune time for the preferred shareholder. In a low interest rate environment, existing preferred shares might be paying a higher yield than the market. This is good for the investor, but expensive for the dividend-paying company. Most would prefer to pay the expense of calling in the shares, rather than pay a high fixed dividend yield on them.

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Example

In the fall of 1997, the Bank of Nova Scotia had an outstanding issue of preferred shares that were callable on October 29, 1997, at their par value of $25 per share. Just prior to the call date the shares were trading at $26.85, a $1.85 per share premium to their par value, calculated as ($26.85 - $25.00).

At the time, the prime rate in Canada was 6.25%. From the Bank of Nova Scotia's perspective, letting the preferred shares remain outstanding and paying the fixed dividend of 9.25% for any longer than necessary would not have made good business sense. Consequently, the company redeemed the shares on the October 29th call date. The Bank of Nova Scotia preferred shares were trading at $25 on October 29th. The $1.85 premium on the shares disappeared once the shares were called.

Dividends

After a corporation sells its products and deducts its costs, it is left with either a profit or a loss.
When there is a profit, the corporation can reinvest the money in their business. Some corporations will use the profits to grow their business and invest the profits in research and development. Others may use the money to buy machinery or invest in technology to increase production.

A company may also allocate a portion of the profits to be shared with common and preferred shareholders in the form of dividends. Dividends are the portion of the corporation’s profit that is not reinvested in the business, but is instead distributed to shareholders.

The decision about how profit is to be used rests with the Board of Directors. If the Board believes a portion of the profits should be distributed to the shareholders, then the corporation will make a public announcement that it will distribute dividends. The date on which the dividend is authorized and announced to the public is called the declaration date. The announcement will include details about the dividend amount that will be allocated to each share.

The date of record will also be indicated. Investors who own the shares as of the date of record are entitled to dividends.

Types of Common and Preferred Shares

To attract investors, corporations can add different features to their common and preferred shares. Some corporations may issue two types of common shares which are denoted as Class A and Class B shares. The differences between the two shares usually relate to voting rights and dividend entitlements. Typically, Class A shares offer more votes per share.

Preferred shares may also come with different features that appeal to the different needs of investors and the corporation. The following are some of the different features that can be added to preferred shares.

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Preferred Share Type	Characteristics
Convertible Preferred Shares	Gives the shareholder the option to convert shares into a fixed number of common shares at a predetermined price within a specified period.
Participating Preferred Shares	Offers the opportunity to receive additional dividends if the company's profit exceeds a stated level. May also have provision that entitles investors to receive an additional amount of the company's assets if the company is liquidated.
Cumulative Preferred Shares	Requires that unpaid dividends accrue and be paid in full before dividends are paid to common shareholders. Non-cumulative dividends do not carry forward missed payments (dividends may be missed if the company does not make a profit).
Callable (Redeemable) Preferred Shares	Allows the issuer to redeem the preferred shares at a pre-determined price within a defined period.
Retractable Preferred Shares	Entitles the shareholder to sell the shares back to the issuer at a pre-determined price and time in the future.

Investment Profile of Common and Preferred Shares

The table below summarizes the investment profile of common and preferred shares.

	Common Share	Preferred Share
Investment Objective	Long-term capital appreciation and potentially income	Stable dividend income
Expected Return	Capital gain and potentially dividend income	Dividend Income
Risk Level	Moderate to high	Low to moderate
Potential Gain	Unlimited	Limited, usually trades around par value
Potential Loss	Up to 100% of capital invested	Up to 100% of capital invested

Equities and Investment Funds

Portfolio managers consider investing in equities to provide potential growth in their portfolios.
Since common shares can provide unlimited price appreciation, more aggressive investment funds tend to hold equities that do not pay dividends but rather retain their earnings to reinvest in the business. The primary objective of these investment funds is capital gains.

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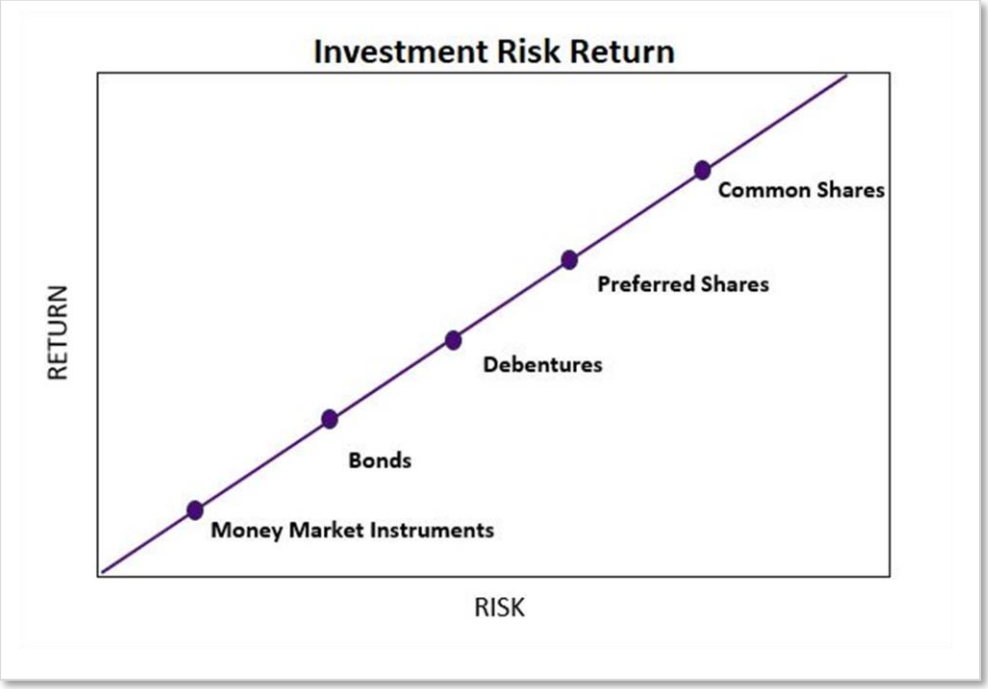
Investment funds where the objective is moderate growth may select common shares from large, stable companies. These companies provide more price stability and perhaps dividend income.

Portfolio managers consider investing in preferred shares primarily for the dividend income since the opportunity for price appreciation is limited. Since dividends provide a tax-efficiency income stream for investors, this type of investment fund is appropriate for non-registered accounts.

Investment Risk and Return

This chart illustrates the risk-return relationship for the different building blocks of mutual funds. Investments that are lower risk offer lower returns. Investments that offer higher potential return also come with greater risk.



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Lesson 4: Derivatives

Introduction

Derivatives are financial instruments that get their value from one or more underlying assets, such as commodities, stocks, bonds, interest rates or currencies. In this lesson you will learn about the different types of derivatives.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- differentiate between hedging and speculating
- describe the main features of:
  - call options
  - put options
- describe the main features of futures contracts and forward contracts
- explain how derivatives are used in investment funds

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Derivatives

Derivatives are financial instruments that get their value from one or more underlying assets. The most common underlying assets include: commodities, stocks, bonds, interest rates, and currencies.
The derivative itself is a contract between two parties, which specifies the conditions under which a transaction is to be made.

Derivatives can be used to hedge risk of unexpected price changes, or in speculative trading. Almost all derivatives have a finite lifespan. At some time, the investor must fulfill the terms of the derivative and buy or sell the underlying asset, or allow the derivative to expire.

The main types of derivatives include the following:

- options
- future contracts
- forward contracts

Hedging

Hedging is a strategy used to reduce the risk of unfavourable price changes. Investors hedge their investments when they are uncertain about the direction of the market and want to protect their asset against adverse price movements.

A hedge usually involves taking an offsetting position, such as entering into an agreement with another party to sell or buy an asset at a predetermined price to prevent loss.

Example

Joe is a soy bean farmer. He wants to ensure that he can sell his crop at a particular price to cover all his costs and to allow him to make a profit. Instead of waiting until he harvests his crop, Joe enters into a derivative contract now to sell his crop at a specified price on a specified date. By entering the contract, Joe guarantees the price he will receive for his crop.

Speculation

Speculation is a strategy intended to increase profit. It involves executing very high-risk financial transactions that have a potential of providing high returns. Trading on the basis of speculation is called speculative trading. This strategy is the opposite of a buy-and-hold strategy, where someone invests in an investment for a long period with the objective of gaining long-term return. Speculative trading involves buying and selling an asset to make a substantial gain in a short period. Someone who engages in speculative trading is called a speculator.

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Example

Indira is a speculative trader. She enters into derivative contracts to buy corn but does not ever intend to purchase the corn or take delivery. She is betting that the price of corn will appreciate substantially over the next few weeks. Before the contracts expire, she must enter into offsetting contracts to close out the transaction so that she does not have to fulfil the purchase and delivery requirements of the contracts.

Investment funds are intended for long-term investors and are not suited for speculative trading.

Options

Options are derivative contracts that give an investor the right to buy or sell a pre-determined amount of an underlying security at a set price for a set period of time. There are two parties involved in an option transaction: the option buyer and the option seller. The option buyer, also known as the holder, has the **right** to buy or sell the underlying security. The option seller, also known as the writer, has the **obligation** to buy or sell the underlying security if the buyer decides to exercise the option. The option buyer must pay the option seller a price for this right, called a premium.

There are options on many different securities, such as stocks, bonds, and indexes, but the most common are stock options.

There are two types of options:

- **Call options** allow the option buyer the right to buy an underlying security at a pre-determined price. They are used when an investor believes the security price will go up in the future.

- **Put options** allow the option buyer the right to sell an underlying security at a pre-determined price. They are used when an investor believes the security price will fall in the future.

Type of Contract	Option Buyer	Option Seller
Call	Right to buy an underlying security	Obligation to sell an underlying security
Put	Right to sell an underlying security	Obligation to buy an underlying security

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Example

Joyce has been following the news about ROBO Co. and she believes the common share price will go up very soon. ROBO's share price is currently $20. She buys a call option at a $2 premium per share, from a seller who is willing to sell the shares for $23 within the next six months.

If the share price goes up to $30, Joyce can exercise her option and buy the shares for $23 and the seller must sell it to her at $23. However, if Joyce's forecast is wrong and the share price actually falls below $23, she has the right not to buy the share. Her loss would be only the premium she paid to buy the option.

Example

Sam owns ROBO common shares, which he purchased for $25. Unlike Joyce, he thinks the price will fall so he buys a **put option**. This gives him the right to sell his shares for a specific price within a specific period. He buys put options at $2 per share, which gives him the right to sell the shares for $20 within the next nine months.

If the price drops to $15, Sam can exercise his option to sell his shares for $20. If the price goes up to $25, Sam will not exercise his option and only lose the premium for the put options.

Futures Contracts

Futures contracts are intended to solve the basic business risk of future price uncertainty. With futures contracts, investors can control as much of the future as possible, in that the contract can set a pre-determined price for a good that is to be delivered at a specific time in the future.

Futures contracts differ from options because there is a legal obligation to buy or sell the underlying asset.

Example

Wheat prices change daily, which affects the profits that wheat farmers can make. If prices go up, farmers can enjoy a large profit but if prices drop, their profits shrink.

Frank is a wheat farmer. Frank can protect himself from a loss by entering into a futures contract with another party, to sell his wheat at $8 per bushel, to be delivered in three months. This way, even if the price drops to $7 a bushel within the next three months, Frank is protected. He has already secured his selling price ahead of time using a futures contract, therefore hedging the risk that wheat prices will fall. On the other hand, if the price of wheat increases to $9 per bushel, the buyer will benefit, since he or she is able to buy wheat from Frank at the agreed upon price of $8.

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The futures market is where producers and users of commodities such as wheat, meats, currency, interest rates, and securities buy and sell contracts. Note that the definition of commodities has been expanded from physical goods to include financial assets.

Buyers of futures are considered to be “long” on the commodity, meaning the commodity will belong to the buyer at a defined time for a specific price. Whereas the seller is said to be “short” on the commodity because they agree to deliver the commodity at a pre-determined price and date and will be short of the commodity after its delivery.

Forward Contracts

A forward contract is an agreement that allows a buyer to purchase an underlying asset such as stocks, bonds, or currency, from a seller for a pre-set price at a specific future date. The provisions of the contract, including the price and sale date, are customized by the seller and buyer.

Forward contracts are similar to futures contracts because there is a legal obligation to buy or sell the underlying asset.

Example

Jerome is a pension fund portfolio manager. He has finalized a deal to fund an infrastructure project in Germany. The agreement stipulates that he make three lump sum instalments: one in six months, the second in a year, and the third in three years. Jerome can enter into a forward contract that will lock in the Canadian-Euro exchange rate at those three points in time. By doing so, Jerome is assured the exchange rate now that he will have to pay in the future.

Differences Between Forward and Futures Contracts

As you can see, forward contracts and futures contracts have the same function. However, they differ from each other in several key ways, as follows:

Forward Contracts	Futures Contracts
• not traded on a centralized exchange, but through a broker-dealer	• traded on the futures exchange
• customized contracts, negotiated between buyers and sellers through broker-dealers	• standardized contracts
• no clearinghouse, therefore it is possible that buyers and sellers may default on contracts	• has a clearinghouse that ensures buyers and sellers follow through on the contract

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Derivatives and Investment Funds

Derivatives such as options, forward and futures contracts are used in the management of investment funds to reduce risk and to maximize profits. One of the ways derivatives are used in investment funds is with hedging currency exchange fluctuations. For instance, Canadian investment funds are mostly denominated in Canadian dollars. However, investment funds that invest outside of Canada will require foreign currency to purchase securities of corporations based outside of Canada.

Within an investment fund, foreign currency must be converted back into Canadian dollars. As a result, exchange rate changes will affect the return of the investment fund.

Generally, if the Canadian dollar is weak and depreciates, the value of foreign assets will increase after their conversion into Canadian currency, which increases the return of the investment fund. However, if the Canadian dollar is strong and appreciates, the value of the foreign asset will fall after it is converted into Canadian dollars, which will reduce the investment fund's return. Derivatives can help manage any downside risk.

Example

Geraldine is a portfolio manager of a U.S. equity fund. She plans to use a forward contract to eliminate the risk of a strong Canadian dollar. The exchange rate for Canadian dollars (CAD) is currently $0.80 U.S. dollars (USD), which means that she can exchange $0.80 USD for $1.00 CAD. If the Canadian dollar appreciates to $0.85 USD, then she must exchange $0.85 USD for $1.00 CAD, which is $0.05 more per Canadian dollar.

Geraldine can sell a USD forward contract that allows her to lock in an exchange rate of $0.80 USD in the future.

In the next year, if the Canadian dollar appreciates such that the exchange rate is $0.85 USD, she will benefit from having used a future contract as a currency hedge. As a result, the return of her fund will not be negatively affected by the change in currency rate.

The provincial securities commission regulates the use of derivatives in investment funds. The rules are stated in National Instrument (NI) 81-102.

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Summary

Congratulations, you have reached the end of Unit 5: Types of Investments.

In this unit you covered:

- Lesson 1: Building Blocks of Investment Funds
- Lesson 2: Fixed Income Securities
- Lesson 3: Equities
- Lesson 4: Derivatives

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 5 **Quiz** button.

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Unit 6: Types of Investment Funds

Introduction

As a Dealing Representative, investment funds are a core element of your role. It is therefore essential that you are well versed in the different types of investment funds. In order to make suitable recommendations for your clients, you must understand the structure of each fund type and how each fund meets different investment goals.

In this unit you will learn about the various types of investment funds including conventional mutual funds, exchange-traded funds, alternative mutual funds, hedge funds, and other investment products and investment funds.

This unit takes approximately 2 hours and 30 minutes to complete.

Lessons in this unit:

- Lesson 1: Introduction to Investment Funds
- Lesson 2: Investment Fund Categories
- Lesson 3: Features and Objectives of Fund Types
- Lesson 4: Exchange-Traded Funds
- Lesson 5: Alternative Mutual Funds and Hedge Funds
- Lesson 6: Other Investment Products and Investment Funds

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Lesson 1: Introduction to Investment Funds

Introduction

Investment funds are central to the business of mutual fund dealers and their Dealing Representatives. Your clients will expect you to have an in-depth understanding about investment funds.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- describe the history of mutual funds and the current environment
- differentiate between closed-end and open-end mutual funds
- explain the different types of mutual funds
- describe the features and benefits of conventional mutual funds

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History of Mutual Funds

The concept of a mutual fund has been around for centuries: mutual funds are an investment option that brings investors together for mutual benefit. The first mutual fund was created in the Netherlands in the late 1700s when a Dutch broker created a trust that was intended to provide small investors with a diversified pool of investments. This early type of mutual fund was adopted in England and France, and then by the United States (U.S.) in the late 1800s. The first open-end mutual fund was created in the U.S. in 1924.

In Canada, the first mutual fund was established in 1932, known today as the CI Canadian Investment Fund.

Closed-End vs. Open-End Mutual Funds

Mutual funds can be structured in two ways:

- closed-end mutual funds
- open-end mutual funds

The earliest mutual funds were closed-end funds. These funds issue a fixed number of units under an initial public offering (IPO). After the IPO, the number of units remains set and investors buy and sell units of the fund through a secondary market such as a stock exchange. Transactions to buy and sell units do not involve the fund issuer and occur between buyers and sellers on the exchange.

The price of a closed-end mutual fund is subject to the market forces of supply and demand. Therefore, the market price of the units may not reflect the fund's underlying net asset value per unit (NAVPU) and may be higher or lower than the NAVPU.

In contrast, open-end mutual funds are offered continuously and there are no restrictions on the number of units issued by the investment fund manager. The investment fund manager will issue more units to satisfy investor demand and will redeem units from investors who want to sell them. Open-end mutual funds are more common than closed-end funds in today’s retail investment market.

Types of Mutual Funds

Today’s investment fund industry is a vast universe of sophisticated products spanning an immense range of investing opportunities. This evolution of the market has expanded the types of mutual funds offered including:

- conventional mutual funds
- exchange-traded funds
- alternative mutual funds

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The shared characteristics of these mutual funds are that they are:

- open-end
- redeemable
- offered by prospectus
- subject to the provisions in National Instrument (NI) 81-102, Investment Funds

Conventional Mutual Funds

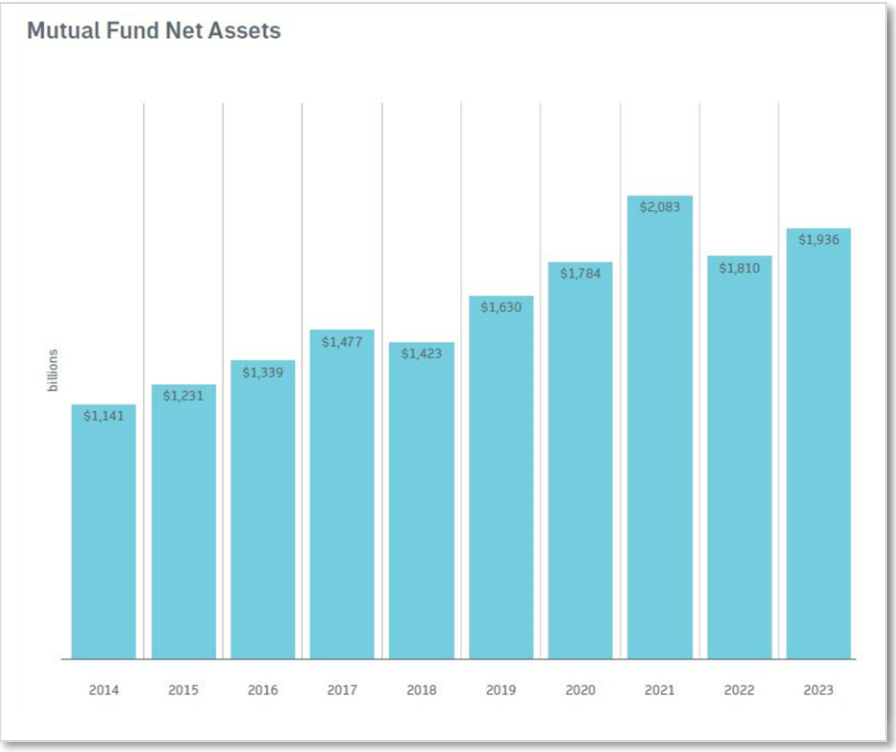
Conventional mutual funds represent the largest segment in the investment fund industry. The investment fund managers for conventional mutual funds pool investor money into diversified portfolios and then price and sell the units of the portfolio.

Conventional mutual funds have the following unique characteristics:

- Conventional mutual funds issue and redeem units for cash.
- Conventional mutual funds are bought and redeemed through the investment fund manager and are not offered on a secondary market.
- Conventional mutual funds are priced based on the underlying asset prices in the fund's portfolio, known as the net asset value per unit (NAVPU). The price always reflects the NAVPU.

Conventional Mutual funds have grown in popularity since their inception in the Canadian market. The largest growth occurred in the 1990s when double-digit interest rates on fixed-income securities, such as guaranteed investment certificates (GICs), began to drop. This made GICs less attractive and savers sought investments with the potential for higher returns. Investors' money flowed into mutual funds.

As shown in the adjacent chart, assets under management have fluctuated over time, but have remained relatively steady.



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Benefits of Mutual Funds

Benefit	Description
Liquidity	Mutual funds are considered to be liquid investments that can be sold and converted to cash very quickly and easily. An investor simply needs to submit a redemption request and the redemption proceeds are usually sent to the investor within one to two business days depending on the type of fund. Some mutual funds may be more restrictive in their redemption policy if the underlying assets within the portfolio cannot be easily sold.
Professional Management	Mutual fund investors benefit from the services of trained investment professionals. Portfolio managers have greater access to research and more sophisticated analytical tools than the average investor. They follow a rigorous process to research, analyze, and select only those securities that they believe best match the investment objectives of the fund.
Diversification	Mutual funds reduce the risk of owning one security by holding different types of securities or securities from a number of different issuers. The average mutual fund can hold dozens or hundreds of different securities. The securities may vary across business sectors, geographical regions, and other factors. By diversifying holdings, mutual funds can ensure that an event that affects one issuer or business sector does not affect the entire portfolio. The average investor would find it difficult and very expensive to duplicate the level of diversification found in a mutual fund. The Fund Facts for a given mutual fund shows the type of investments held in the fund.
Low Cost	There is a cost benefit of owning a mutual fund because the expenses of running the fund are shared amongst thousands of investors. Professional management and the administration of the fund would be very expensive for a single investor. By sharing the costs with a number of investors, the cost of owning a mutual fund is affordable for most regular investors.
Convenience	With over 3,300 different mutual funds in Canada, investment fund managers are continuously competing for business by improving their customer service offerings. The majority of mutual fund companies allow investors to view their mutual fund holdings online and many allow investors to transact business online.

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Lesson 2: Investment Fund Categories

Introduction

There are different types of investment funds, each one intended to address different investment goals. As a Dealing Representative, you need to be well versed in the different types of funds so that you can determine investment funds that will be suitable for your clients.

In this lesson you will learn about the types of investment funds and their main characteristics.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the role of the Canadian Investment Funds Standards Committee (CIFSC)
- provide an overview of how investment funds are categorized under the CIFSC
- define each of the categories under the CIFSC Retail Investment Fund Category Definitions
- explain the types of income that can be generated and distributed by investment funds
- explain fund risk classification
- compare the risk return relationship of the different types of investment funds

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Canadian Investment Funds Standards Committee (CIFSC) Categories

To help investors and industry participants make sense of the multitude of investment fund offerings, the major data providers and research firms in Canada have formed the Canadian Investment Funds Standards Committee (CIFSC). The CIFSC sets the standards used to classify investment funds into specific categories that are formally defined in a document called the *Retail Investment Fund Category Definitions* ("CIFSC Categories"). The CIFSC Categories are based on the underlying assets that may be held within an investment fund using five (5) security/asset types: cash, fixed income, equities, commodities, or other assets.

CIFSC Security Types	
Security Type	**Securities**
Cash	• Cash and short-term notes • Fixed income with a maturity of less than 1 year
Fixed Income (maturity of 1 year or more)	• Bonds • Convertible Bonds • Preferred Shares • Convertible Preferred Shares • Mortgages, Mortgage-Backed Securities, Asset-Backed Securities • Floating-Rate Notes
Equities	• Common Shares • Income Trusts
Commodities	• Physical Commodities • Commodity Derivatives
Other	• Futures • Options • Other Derivatives • Rights • Warrants • Real Estate • Investment Funds • Other Assets and Liabilities

The CIFSC has also established classifications for:

- geographical regions
- business sectors
- market capitalization

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Investment funds in Canada are expected, but not required, to use the CIFSC Categories when classifying their funds in their stated investment mandate. The CIFSC also conducts quantitative screening of investment funds listed in Canada and publishes the CIFSC Fund List with each fund's CIFSC classification.

The CIFSC Categories are summarized below.

CIFSC Categories		
Category	**Definition**	**Sub-Categories**
Money Market Funds	• must invest at least 95% in cash or cash equivalent securities • must otherwise comply with the legal definition of money market funds under National Instrument (NI) 81-102	• Canadian Money Market • U.S. Money Market
Fixed Income Funds	• must invest at least 95% in fixed-income securities/assets	• Canadian Short-Term Fixed Income • Canadian Fixed Income • Canadian Corporate Fixed Income • Canadian Long-Term Fixed Income • Canadian Inflation Protected Fixed Income • Global Fixed Income • Global Corporate Fixed Income • High Yield Fixed Income • Preferred Share Fixed Income • Floating Rate Loan • Emerging Markets Fixed Income • Multi-Sector Fixed Income
Balanced Funds	• must invest between 5% and 90% in equities • must invest between 10% and 95% in fixed-income securities/assets	• Canadian Equity Balanced • Canadian Neutral Balanced • Canadian Fixed Income Balanced • Global Equity Balanced • Global Neutral Balanced • Global Fixed Income Balanced • Tactical Balanced

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CIFSC Categories		
Category	**Definition**	**Sub-Categories**
Target Date Funds	• must comply with the "Balanced Fund" category • must have specific, pre-determined maturity dates and a stated mandate to adjust the target asset allocation weightings over time as maturity dates approach • upon maturity, must move to the "Fixed Income" or "Balanced" category	• Short-Term Target Date Portfolio • Specific Maturity Date Target Date Portfolio (e.g. 2035 Target Date Portfolio, etc.)
Equity Funds	• must invest at least 90% in equities	• Canadian Dividend & Income Equity • Canadian Equity • Canadian Small/Mid Cap Equity • Canadian Focused Equity • Canadian Focused Small/Mid Cap Equity • US Dividend & Income Equity • U.S. Equity • U.S. Small/Mid Cap Equity • North American Equity • Asia Pacific Equity • Asia Pacific ex-Japan Equity • Greater China Equity • European Equity • Emerging Markets Equity • Global Dividend & Income Equity • Global Equity • Global Infrastructure Equity • Global Small/Mid Cap Equity • International Equity • Financial Services Equity • Precious Metals Equity • Natural Resources Equity • Real Estate Equity

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CIFSC Categories		
Category	**Definition**	**Sub-Categories**
		• Energy Equity • Geographic Equity • Sector Equity
Alternative Funds	• invests in alternative strategies/investments	• Alternative Equity Focused • Alternative Credit Focused • Alternative Multi-Strategy • Alternative Market Neutral • Alternative Private Equity • Alternative Private Debt • Alternative Other
Specialty Funds	• has a unique strategy that does not belong to any other category	• Retail Venture Capital • Passive Inverse/Leveraged • Miscellaneous - Income & Real Property • Miscellaneous - Other • Miscellaneous - Undisclosed Holdings
Commodity Funds	• must invest primarily in physical commodities or gain exposure to commodities using derivatives • the commodity exposure must be primarily long and must not be leveraged	• Commodity

Fund Income Type

Investment funds earn and distribute various types of income. It is important to be able to differentiate the income that can be generated by investment funds to understand:

- the likelihood that income will be earned
- the frequency of the income
- the tax implications of the income

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The table below lists the types and characteristics of income distributed by investment funds.

Fund Income Type		
Income	**Description**	**Characteristics**
Interest	• interest payments from fixed-income securities	• likelihood of payment is high, especially from creditworthy issuers • frequency of payment is set out in the terms
Canadian Dividend	• profit from Canadian companies • earned from preferred and common shares	• likelihood and frequency of payment is usually high with large, established companies
Capital Gains	• profit from the sale of a security for a higher price than its original purchase cost	• only occurs when there is price appreciation and disposition at a higher price
Foreign Non-Business Income	• interest or dividend payments from non-Canadian investments	• likelihood and frequency of payment is usually high with large, established issuers
Return of Capital (not considered income for tax purposes)	• return of investors' money	• occurs when distributions exceed earnings in the fund

Fund Risk Classification

The risk classification of an investment fund is measured by the fund's historical price volatility: the amount and frequency that the net asset value per unit (NAVPU) fluctuates over time. Funds with high volatility experience a significant rise and fall in their NAVPU over a short period while funds with low volatility have a stable NAVPU.

As prescribed under National Instrument (NI) 81-102, Investment Funds, a fund's risk classification is determined by its 10-year standard deviation. If the fund does not have 10 years of performance history, a suitable proxy index is used to fill in the gap. For example, if a fund has 5 years of performance history, the calculation will take 5 years of history from the fund and 5 years from the proxy index to calculate the 10-year standard deviation. The corresponding risk levels are as follows:

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Fund Risk	
Standard Deviation Range	**Investment Fund Risk Level**
0 to less than 6	Low
6 to less than 11	Low to Medium
11 to less than 16	Medium
16 to less than 20	Medium to High
20 or greater	High

An investment fund's CIFSC Category can often be indicative of its risk classification because both are linked to the fund's underlying holdings in its portfolio, but the CIFSC category does not determine the risk category. The summary below shows the risk classifications that are generally common given a fund's category. That said, risk classification will be specific to each and every fund and it is important to refer to the Fund Facts for the fund including the risk and investment objectives sections.

Fund Risk Classification				
Category	**Investment Objective**	**Type of Income**	**Underlying Investments**	**Risk Classification**
Money Market Funds	• safety and income	• interest	• money market instruments	• low
Fixed Income Funds	• income	• primarily interest • can generate capital gains	• bonds • convertible bonds • preferred shares • convertible preferred shares • mortgages, mortgage-backed securities, asset-backed securities • floating-rate notes	• low • low to medium • medium

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Fund Risk Classification				
Category	**Investment Objective**	**Type of Income**	**Underlying Investments**	**Risk Classification**
Balanced Funds	• combination of income and long-term growth	• interest • dividends • capital gains	• fixed income securities/assets • equities	• low to medium • medium
Target Date Funds	• specific, pre-determined maturity date • a stated mandate to adjust the target asset allocation weightings over time as the maturity date approaches	• interest • dividends • capital gains	• equities • fixed income securities/assets	• low to medium • medium
Equity Funds	• long-term growth	• capital gains • dividends • other income	• equities	• medium • medium to high • high
Alternative Funds	• alternative strategies/investments	• capital gains • dividends • other income	• equities • fixed income securities/assets • options • futures • other derivatives • leverage	• low to medium • medium • medium to high • high
Specialty Funds	• long-term growth • speculation	• capital gains • dividends • other income	• venture capital • real estate • inverse/leveraged • other miscellaneous	• high
Commodity Funds	• aggressive growth • speculation	• capital gains • other income	• physical commodities • exposure to commodities using derivatives	• high

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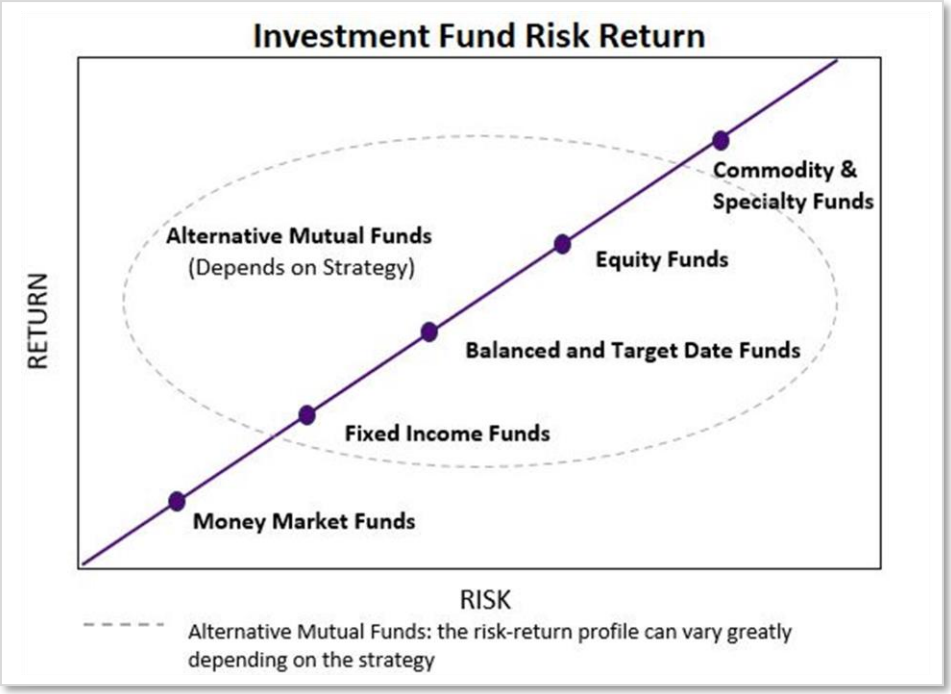
Risk Return Relationship

Another consideration to keep in mind when evaluating investment funds is the relationship between risk and return.

More conservative investment funds typically have lower returns in exchange for lower risk. More growth-oriented or aggressive investment funds have the potential for higher returns, but at a higher risk. Higher risk can translate into potential losses.



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Lesson 3: Features and Objectives of Fund Types

Introduction

The different types and categories of investment funds each have unique features and characteristics dictated by the underlying assets within their portfolios. The different types of investment funds each have mandates to achieve different investment needs and goals. As a Dealing Representative, you need to be well versed in the features and objectives of the different types of funds so that you can determine investment funds that will be suitable for your clients.

In this lesson you will learn about the features and objectives of the different types of funds.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the main features and objectives of the following fund types:
  - money market funds
  - fixed income funds
  - balanced funds
  - target date funds
  - equity funds
  - specialty funds
  - commodity funds
- explain responsible investing (RI), environmental, social, and governance (ESG) criteria, and RI and ESG funds
- explain the fund of funds structure

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Overview of Fund Types

Investors with a lower risk profile will typically seek a more conservative approach such as those provided by money market, fixed income, or balanced funds. Money market and fixed income funds focus primarily on safety of capital and steady income while balanced funds aim for a combination of income and growth. Target date funds also offer a more conservative approach to investing using a graduated combination of growth and income.

Investors who are seeking higher returns and have the tolerance and capacity for higher risk will be interested in growth-oriented investment funds. Growth-oriented funds include equity funds, which offer the opportunity for capital appreciation, and specialty and commodity funds, which offer aggressive growth or speculation.

It is important to explore and understand how each of these types of funds work.

How Money Market Funds Work

Money market funds are safe investments that are typically used as a secure place to deposit money. The investment objectives of money market funds are safety of principal (i.e. protection of investor's money) and income.

Money market funds invest in low-risk, high quality instruments with terms to maturity of less than one year. By law, the average weighted term to maturity of a fund’s portfolio must not exceed 180 days. Although the investments within these funds fluctuate with general interest rate levels, money market funds are managed in such a way that the fund price remains constant, typically $1 or $10. This makes money market funds very stable. Only under very rare circumstances does the net asset value per unit (NAVPU) of a money market fund fluctuate.

Money market funds pay interest on a monthly basis. Investors can reinvest the interest automatically or receive it as income. Investment returns for money market funds move in the same direction as general interest rates and are commonly better than the return received from a traditional bank account.

Money Market Funds Profile	
Investment Needs and Objectives	Safety and income
Type of Income	Interest
Holdings	• treasury bills (T-bills), commercial paper, provincial and municipal short-term paper domiciled in Canada • U.S. money market instruments denominated in U.S. currency
Risk Classification	Low

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How Fixed Income Funds Work

Fixed income funds invest in holdings of fixed income securities and assets including government bonds, corporate and convertible bonds, preferred shares, mortgages and mortgage-backed securities, asset-backed securities, and floating-rate notes.

The main objective of fixed income funds is to produce income that can be paid to unitholders on a monthly basis. There may also be capital gains when there are dispositions of holdings within the fund.

Fixed income funds can be classified in different ways including:

- by the creditworthiness of the asset (i.e. bond, corporation, mortgage, etc.)
- by the average term to maturity

Generally, when creditworthiness is high, the asset will pay a lower rate of income. For example, investment grade bonds involve lower risk and therefore pay lower interest rates, while bonds with higher risk pay higher income to compensate investors for the additional risk. Likewise, dividend-paying corporations that are large, established businesses with a history of providing steady dividend payments are lower risk. The mandate of the fixed income fund will specify whether a portfolio manager is restricted to higher quality assets (e.g. investment grade bonds) or whether the mandate allows investment in lower quality assets.

The CIFSC classifies asset quality in funds as follows:

- **fixed income fund** – average credit quality is investment grade (BBB or equivalent rating or higher) and not more than 40% of the portfolio's holdings are in high yield securities
- **high yield fixed income fund** – average credit quality is below investment grade (lower than BBB or equivalent) or 40% or more of the portfolio's holdings are high yield securities

Fixed income funds can also be classified according to the average maturity of the assets held in the fund (maturity refers to length of time before the asset matures and the principal is repaid). The CIFSC classifies term as follows:

- **short-term -** average duration of less than 3.5 years
- **long-term -** average duration greater than 9.0 years

Funds invested in mortgages usually hold fully insured mortgages guaranteed by the Canada Mortgage and Housing Corporation (CMHC), a Government of Canada agency primarily involved in providing mortgage loan insurance. These funds normally fall under the short-term fixed income category and have lower price volatility because the average term to maturity is under 3.5 years.

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Funds invested in preferred shares generate tax-preferred dividend income because dividends from Canadian companies benefit from the dividend tax credit. This credit reduces the amount of tax that investors pay on their dividend income.

Fixed Income Funds Profile	
Investment Needs and Objectives	Steady income
Type of Income	Interest, dividend income, some capital gains
Holdings	• government bonds • corporate and convertible bonds • preferred shares and convertible preferred shares • mortgages, mortgage-backed securities, and asset-backed securities • floating-rate notes
Risk Classification	Low, Low to Medium, Medium

Interest rate changes have a great impact on fixed income prices. When interest rates go up, the value of fixed income funds goes down. Conversely, when interest rates fall, the value of fixed income funds goes up. The portfolio manager can minimize some of the risks associated with fixed income holdings, such as interest rate changes and creditworthiness of issuers, by maintaining a diversified portfolio of different assets. The portfolio manager can also adjust the maturities of the assets to take advantage of different stages of the economic cycle. Longer maturity assets can be used when interest rates are low or falling and short-term maturity assets can be used during periods of high or rising interest rates.

How Balanced Funds Work

Balanced funds invest in a combination of equities and bonds. The investment objective of balanced funds is a combination of long-term capital growth and income.

The fixed income holdings in balanced funds offer a measure of stability and income, while the equity portion provides some income through dividends and long-term growth, in the form of capital appreciation. With this combination of fixed income and equities, balanced funds have the potential to provide a higher return than a fixed income fund but with lower volatility than an equity fund.

Under the CIFSC standards, balanced funds must hold:

- between 5% and 90% in equities
- between 10% and 95% in fixed-income securities/assets

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Balanced funds generally state their target asset allocation in the fund's prospectus. For instance, a balanced fund may establish a target asset allocation of 60% equities, 35% fixed income, and 5% cash. There is usually a range specifying the minimum and maximum limits for each asset class rather than exact percentages.

The investment goal of the fund will determine its asset allocation. To achieve the goal, the portfolio manager can use:

- **target asset allocation –** The portfolio manager analyzes the long term expected returns and risk levels of each asset class to set a target asset mix that would match the requirements of the balanced fund. From time to time, the value of the securities in the fund may change and cause the assets held in the fund to deviate from the fund's target asset allocation. When this happens, the portfolio manager will rebalance the mix to return to the target asset allocation.

- **tactical asset allocation –** The portfolio manager has the flexibility to change the asset allocation in the fund to take advantage of opportunities in the market. For instance, the portfolio manager can change the asset allocation from 65% equities, 35% fixed income, and 5% cash to 80% equities, 15% fixed income, and 5% cash. Whether these tactical allocations are permitted on a short-term or longer-term basis will be outlined in the fund's prospectus. There may be higher risk with tactical asset allocation funds since weightings in equities can be higher for longer.

Balanced Funds Profile	
Investment Needs and Objectives	Income and long-term growth
Type of Income	Interest, dividends, and capital gains
Holdings	Equities and fixed income securities/assets
Risk Classification	Low to Medium, Medium

How Target Date Funds Work

Target date funds (also known as life-cycle funds) are a type of balanced asset allocation fund that focuses on a specific future date. The asset mix for the fund will change throughout the life of the fund until the final target date. The investment objective of target date funds is to provide a balance of income and long-term capital growth, relative to the target date.

Under the CIFSC standards, target date funds must:

- comply with the "balanced fund" category and hold:
  - between 5% and 90% in equities
  - between 10% and 95% in fixed-income securities/assets

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- have specific, pre-determined maturity dates and a stated mandate to adjust the target asset allocation weightings over time as the maturity dates approach
- upon maturity, the allocation must move to the “fixed income” or “balanced” category

In the early stages of a target date fund, the portfolio commonly holds a greater percentage in equities. Over time, the asset mix is adjusted away from equities and towards fixed income, thereby reducing risk exposure as the target date approaches. For this reason, target date funds can be ideal for meeting an investment goal in the future, such as the start of an investor's retirement or a child's post-secondary education.

Example

Wilma is 40 years old and plans to retire in 25 years, when she turns 65. She can buy a fund with a target date set for 25 years from now. Over the next 25 years, the portfolio manager will adjust the asset allocation of the fund to gradually lower the equity holdings while increasing the fixed income holdings in the fund. When the fund matures in 25 years, the fund’s portfolio will be largely composed of fixed income, with a lower percentage of the fund invested in equities. The portfolio at the target date will be suited to Wilma’s retirement needs.

NOTE: The asset allocation will vary among target date funds offered by different investment fund managers.

Target Date Funds Profile	
Investment Needs and Objectives	balance of income and long-term capital growth, relative to the target date
Type of Income	Interest, dividends, and capital gains
Holdings	Equities and fixed income securities/assets
Risk Classification	Low to Medium, Medium

The risk level of target date funds changes as the asset mix is adjusted throughout the fund's life. It may start off higher in the early stage of the fund and decline as the fund reaches its target date.

How Equity Funds Work

Equity funds invest primarily in the common shares of corporations. Under the CIFSC standards, equity funds must invest at least 90% in equities. The investment objective of equity funds is long-term capital growth.

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Equity Funds Profile	
Investment Needs and Objectives	Long-term growth
Type of Income	Capital gains, dividends, and other income
Holdings	Common shares but may also hold preferred shares
Risk Classification	Medium, Medium to High, High

There is a large universe of equity funds that are arranged into 25+ different CIFSC sub-categories based on geographical regions, business sectors, market capitalization, and other investment mandate parameters.

Equity Fund Classifications		
Classification	**Definition**	
Geographical Region	• based on the location of the issuer (i.e. corporation)	
	Canadian Equity	• at least 90% in Canadian equities
	U.S. Equity	• at least 90% in U.S. equities
	Global Equity	• in equities of countries anywhere across the world • more than 10% and less than 90% in Canadian/U.S. equities
	International Equity	• at least 90% in the equities of countries other than Canada or the U.S. • at least 70% in developed countries
Business Sector	• based on the industry sector concentration (ISC) score	
	Natural Resources	• companies involved in the extraction and or production of natural resources including: - metals and minerals - oil and natural gas - forestry - fertilizer - coal - chemicals

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Equity Fund Classifications		
Classification	**Definition**	
	Energy	• companies involved in the exploration and or production of oil and natural gas
	Precious Metals	• companies mining primarily in: - gold - silver - platinum - other precious metals
	Financial Services	• companies involved in financial services including: - banking - insurance - real estate - asset management - capital markets
	Real Estate	• companies operating in the real estate industry including: - property owners - development - management - real estate investment trust (REITS)
	Health Care	• companies operating in the health care industry including: - healthcare equipment and supplies - healthcare service providers - pharmaceuticals - biotechnology
Market Capitalization	• per geographical region • thresholds are published quarterly on the CIFSC website (NOTE: the thresholds below are at Dec 31, 2023)	
	Canadian Small/Mid Cap Equity	• not exceeding $5.330 billion (CAD)

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Equity Fund Classifications		
Classification	**Definition**	
	Canadian Focused Small/Mid Cap Equity	• not exceeding $9.203 billion (CAD)
	U.S. Small/Mid Cap Equity	• not exceeding $18.240 billion (CAD)
	Global Small/Mid Cap Equity	• not exceeding $16.650 billion (CAD)

Investors seeking to invest in equity funds should have a higher risk profile and longer time horizon than those who want to focus on conservative investments. Investors need to be able to tolerate and withstand volatility and potential losses. In general, equity funds that invest in small cap corporations are higher risk than those that invest in large cap corporations. More narrowly focused funds in terms of the business sector will also generally be higher risk than more broadly diversified funds.

Global and international equity funds provide the opportunity for Canadian investors to gain broader diversification into different markets. Canada represents less than 5% of the global market and its market is largely concentrated in three sectors: energy, finance, and materials. However, it is important to weigh the potential increase in diversification and returns in terms of risk. Global and international equity funds typically involve different risks than Canadian equity funds due to the risks that can be associated with foreign countries including:

- fluctuations in the currency exchange rate
- political environment instability
- economic uncertainties

For emerging and developing countries, these risks can be magnified because their markets are less regulated than markets in developed countries.

Investment funds that have more concentrated portfolios, whether by market cap, sector, geographic region, or other allocation parameter, are inherently tied to the fortunes of the concentrated portfolio. Therefore, the funds will have higher inherent risk. Dealing Representatives and their clients should refer to the investment objectives and risk sections of the Fund Facts to learn more about each equity fund before investing.

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How Specialty Funds Work

Specialty funds are those that have a unique strategy that do not belong to any of the other fund categories including:

- retail venture capital
- real estate
- passive inverse/leveraged strategies
- other miscellaneous investments/strategies

The investment objective for many specialty funds is long-term growth or speculation and the risk classification is high.

Specialty Funds Profile	
Investment Needs and Objectives	Long-term growth, speculation
Type of Income	Capital gains, dividends, and other income
Holdings	Retail venture capital, real estate, passive inverse/leveraged strategies, other miscellaneous investments/strategies
Risk Classification	High

Retail venture capital funds include, but are not limited to, labour-sponsored investment funds (LSIFs). LSIFs invest in Canadian venture capital (i.e. start-up companies). While LSIFs may offer tax benefits in certain jurisdictions, the federal tax credit once offered by the Government of Canada has been eliminated. For jurisdictions offering tax credits, investors must hold the LSIF for eight years to maintain the credits or the credits must be returned to the government. The low liquidity of LSIFs, combined with the fact that they are invested in high risk companies, makes LSIFs a high risk investment choice.

Real estate funds invest in real estate properties. Investors receive returns from rental income and capital gains from properties sold at a profit. Unlike other investment funds, the values of real estate funds are based on the appraised value of the properties held in the portfolio which do not change daily. Therefore, real estate funds are not priced daily and unit prices are set monthly or quarterly. This means that investors may only be able to redeem the funds at specified times. In cases where the fund does not have enough cash on hand, the redemption requests may only be partially filled. The low liquidity of real estate funds and their concentration in the real estate sector makes real estate funds high risk.

Investment funds that use an “inverse” strategy seek to provide daily performance, before fees and expenses, that is the inverse (or opposite) of the daily performance of a benchmark. Investment funds that use a “leveraged” strategy seek to provide daily performance, before fees and expenses, which is equal to a multiple

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of the daily performance of a benchmark (e.g. the benchmark X 2). Some funds combine the strategies, for example inverse-leveraged. To achieve their investment objectives, these funds borrow money and/or use derivatives such as forwards, futures and options.

Inverse/leveraged funds are typically used in sophisticated trading strategies employed by institutional investors (i.e. large companies such as asset managers of investment funds and other pooled investments). Inverse/leveraged funds are highly complex financial instruments that are often designed to achieve their stated objectives on a daily basis. Due to the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective. As such, inverse/leveraged funds are unsuitable for retail (individual) investors in general, and are only suitable for very sophisticated investors such as institutional investors.

How Commodity Funds Work

Commodity funds invest primarily in physical commodities or gain exposure to commodities using derivatives. Commodity exposure in the funds must primarily be held long and must not be leveraged. The investment objective is capital growth or speculation.

Commodity Funds Profile	
Investment Needs and Objectives	Aggressive growth, speculation
Type of Income	Other income
Holdings	Physical commodities, options contracts, commodity futures, and forward contracts
Risk Classification	High

Commodity funds can employ alternative trading strategies and the managers can engage in speculative trading by investing in:

- specified derivatives
- physical commodities

Some of the investments that may be found in a commodity fund are physical commodities, commodity futures, and forward contracts for grains, meats, metals, energy products, and coffee. When held by themselves, commodity funds are high-risk investments because they are highly concentrated, and fund performance can be extremely volatile. Therefore, commodity funds should only be considered in low concentrations and only for sophisticated investors who are able to understand and accept the risks associated with exposure to commodities.

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Responsible Investment (RI) Funds

Responsible investing (RI) is an approach that employs some combination of environmental, social, and governance (ESG) factors in the selection of investments. In general terms, the investment process uses ESG criteria to identify and select companies that strive to have a positive and sustainable impact on society.

Environmental, Social, and Governance (ESG)	
Criteria	**What the Criteria Measures**
Environmental	• the impact that the company has on the environment • the impact that the changing environment will have on the company
Social	• how well the company: - treats its employees and customers - deals with human rights - avoids corruption • the impact the company has on the community • how the community impacts the company
Governance	• the company's: - leadership - executive compensation - board oversight - board diversity - internal controls - shareholder rights

Investment funds that identify as "RI" or "ESG" funds in Canada are expected to uphold the principles and disclosure standards set out by the:

- Canadian Securities Administrators (CSA)
- Canadian Investment Funds Standards Committee (CIFSC)
- Chartered Financial Analyst (CFA) Institute's Global ESG Disclosure Standards for Investment Products

The CIFSC has established a formal framework, the Responsible Investment Identification Framework, to identify RI funds and the RI approaches that funds use. The framework is complementary to the asset-based categories (money market, fixed income, balanced, target date, equity etc.) and is not a separate

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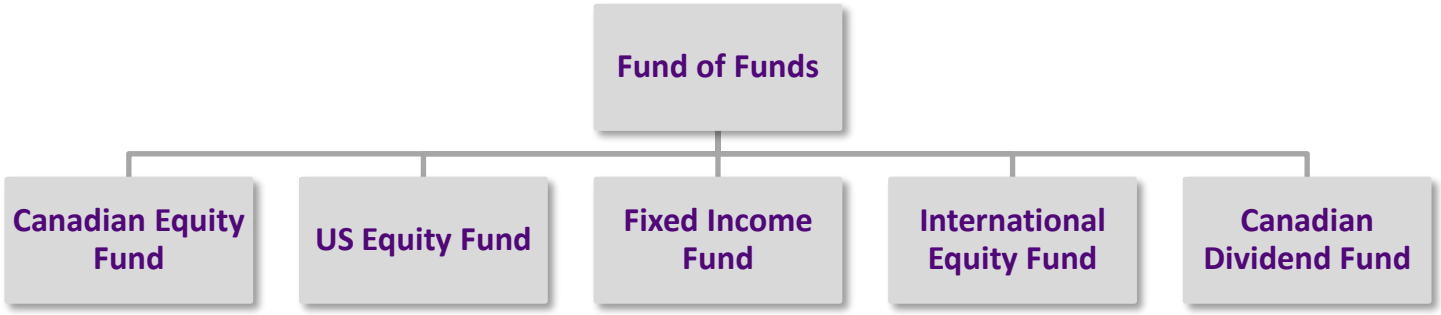
categorization process. The RI framework can be thought of as a set of flags or checkboxes for funds that use an RI approach. The CIFSC publishes its Responsible Investment (RI) Fund List on its website with the ESG criteria for each fund on the list.

Fund of Funds

A fund of funds (FOF), also called a wrap fund or a managed portfolio solution, invests in a basket of investment funds, often from the same investment fund manager. As illustrated below, the FOF creates a diversified portfolio of investment funds to meet a specific investment objective rather than individual securities.



FOFs offer investors the convenience of a pre-set investment portfolio. They are suited for investors who want a simple solution and do not have the time or expertise to customize or rebalance a portfolio of their own.

Investment fund managers usually offer a series of managed portfolios that range from conservative to moderate to aggressive growth. Since the funds may hold a mix of equities and fixed income, the FOFs may provide steady income or long-term capital growth, or a combination. The risk level varies according to the asset mix of the FOF. The diversified nature of these funds can make them lower risk than stand-alone investment funds which invest directly in equities and fixed income.

FOFs employ a multi-manager approach, which means the investor gets the professional expertise of a portfolio manager from each investment fund held in the fund of funds. This way, the investor can get professional investment management across asset classes, sectors, countries, and investment styles.

FOFs automatically rebalance their portfolios to adhere to their target asset allocations. For instance, if the value of equity holdings increases, the portfolio manager may reduce the equity holdings to return the fund to its target asset allocation within the fund of funds.

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It is important for Dealing Representatives and investors to be mindful of the FOF fee structure. There are often two sets of management expense fees:

- the management fees of the fund of funds
- the management expense fees of the underlying investment funds

This dual set of management fees will be charged to the FOF and will impact investor returns accordingly.

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Lesson 4: Exchange-Traded Funds (ETFs)

Introduction

Exchange-traded funds (ETFs) are mutual funds that trade on the stock exchanges. It is important for Dealing Representatives to have a good understanding of ETFs because they have become a mainstream investment option for clients seeking investment funds.

In this lesson you will learn about ETFs, index investing, and trading ETFs.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of ETFs
- explain how ETF units are created and redeemed
- explain how ETFs are bought and sold on the exchanges
- explain index investing, index construction, and index funds
- discuss trading on the exchanges and listed markets
- explain how to buy and sell ETFs
- compare ETFs and conventional mutual funds

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Overview of Exchange-Traded Funds

Exchange-traded funds (ETFs) are open-end mutual funds, and like conventional mutual funds, they are diversified portfolios of pooled investor money that can issue an unlimited number of units. ETFs also have the following unique characteristics:

- ETFs issue and redeem units in consideration for a portfolio of securities rather than for cash. This process is known as in-kind creation and redemption.
- ETFs trade on stock exchanges or other listed markets throughout the day at intra-day prices.
- The majority of ETFs use a passive investing approach, most commonly with the purpose of replicating a stock or market index.

While ETFs are commonly designed to replicate the performance of an index, they can also engage in active management or alternative investment strategies.

Creation and Redemption of ETF Units

While conventional mutual funds issue and redeem units for cash, ETFs issue and redeem units in exchange for an in-kind basket of securities. ETFs issue creation units and redeem redemption units at their net asset value per unit (NAVPU). The in-kind creation and redemption of units is done at the ETF's NAVPU which plays a key role in ensuring that the market price on the exchange remains very close to the ETF’s NAVPU.

ETFs issue new creation units to dealers known as designated brokers. When a dealer subscribes for new units, it hands over to the ETF a basket of securities that approximates the holdings of the fund together with a balancing cash amount. In return, the broker receives units of the ETF which it sells to investors on the exchange at the prevailing market price.

While ETF providers may allow redemptions in cash, this is typically at a discount, such as 95% of the closing price of the ETF. This discount discourages ETF unitholders from requesting cash redemptions from the fund and encourages investors to trade their units on the listed exchanges.

While it is important to understand how ETFs create and redeem units, it is uncommon for Dealing Representatives or their retail clients to be involved in these transactions. Generally, Dealing Representatives and their clients will only be involved in buying and selling ETFs at their listed price on the stock exchange.

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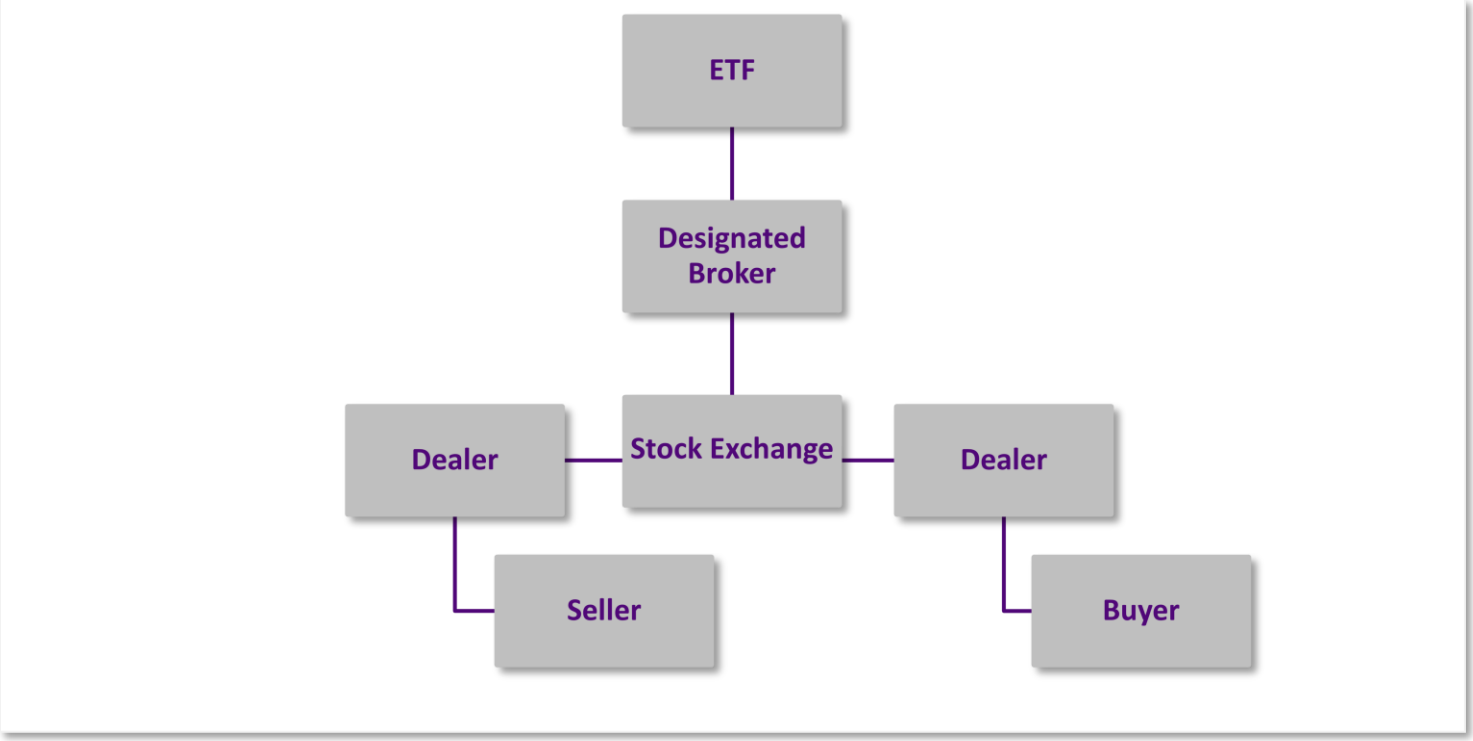
How ETFs are Bought and Sold on the Exchanges

Unlike conventional mutual funds, investors buy and sell ETFs on the stock exchange through their dealers. The trades do not affect the number of outstanding units because the units pass from one investor (the seller) to another investor (the buyer). The ETF's fund manager does not see any of the money for the trades because the money goes from the buyers to the sellers.



If the demand from investors to buy units exceeds the number of units for sale, a designated broker will supply units from its inventory or will subscribe for new units from the ETF. This will increase the number of units outstanding and serve to meet the demand. When this happens, the designated broker is said to be acting as a market maker.

If the supply of ETF units by investors exceeds the number of units that investors want to buy, the designated broker will buy them and add them to their inventory. If their inventory is already full, the dealer will redeem units with the ETF. This will decrease the number of units outstanding and supply and demand will again become balanced. Here again, the designated broker is acting as a market maker.

Price of ETFs

The price of an ETF unit depends on supply and demand factors. The price fluctuates during the trading day, depending on general market conditions. However, as with any other mutual fund, the value of the underlying assets has a greater impact on the pricing. The in-kind creation and redemption of units ensures that the price and the NAVPU remain aligned.

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Example

Halden wants to invest $100,000 in the Nordan Real Estate Investment Trust (REIT) ETF. This amount is greater than a typical day's volume. Since the underlying securities are all very liquid, the ETF can create additional units based on the NAVPU to satisfy investor demand. Halden's trade will not move the ETF price because new units are created.

Intra-day trading is a characteristic of ETFs because their units may be bought and sold at the prevailing price throughout the trading day, which may diverge from the NAVPU.

At the end of the day's trading session, an ETF's market price should be close to its NAVPU. In the case of ETFs with low liquidity, there is a risk that the NAVPU may be different from the ETF's market price at the end of the day.

Index Investing

A market index is simply a number that represents a market. The most widely quoted market index is the Dow Jones Industrial Average. The Dow Jones Industrial Average is comprised of 30 large companies in the United States (US) which are considered industry leaders.

Market indices are used to provide:

- a measure of broad market movements
- a benchmark to evaluate performance
- a basis for index investing

Today, index investing has become mainstream. Summarized in the table below are the main types of index construction.

Index Construction	
Index Type	**Description**
Price-Weighted	• the weight of each company depends on the share price • the sum of the prices of each of the companies is divided by the number of companies • example: Dow Jones Industrial Average

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Index Construction	
Index Type	**Description**
Capitalization-Weighted	• assigns weights to each company according to its market capitalization (“market cap”) • market cap = number of shares outstanding times the market price per share
Float-Adjusted	• assigns weight to each company according to their float-adjusted capitalization rather than total capitalization • float-adjusted cap = shares outstanding minus large blocks held by strategic shareholders
Capped	• caps the relative weight of any single company at a given percentage of the index • fosters broad diversification to avoid concentration
Equal-Weighted	• assigns the same weight to all companies, regardless of size (market-cap) • the smallest company in the index will have the same weight as the larger companies
Price Return	• based only on the price changes of the stocks
Total Return	• based on both the price changes and the dividends of the stocks
Industry Sector	• comprised of stocks in a given industry sector
Alternative Weighting	• based on a clearly defined strategy such as value, size, momentum, quality, low volatility, or growth

Index Funds

An index fund is an investment fund whose objective is to replicate the performance of a market index, net of fees and expenses. The majority of ETFs are index funds. ETFs and other index funds use a number of investment strategies including:

- replication
- sampling
- derivatives

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Replication

ETFs that use a replication investment strategy hold all of the index components in the same proportion as the index. This means that the relative weight of each security in the portfolio is the same as in the index. An ETF that uses a replication strategy will usually track its index very closely, before fees and expenses.

Sampling

ETFs that use a sampling investment strategy do not hold all of the index components. Instead, the ETF selects a representative sample of securities that matches the investment characteristics of the index as a whole. Fixed income ETFs will typically use a sampling strategy because it is difficult to access all the securities in the index. Sampling may also involve investing in securities that are not index components and in derivatives. An ETF that uses a sampling approach will be less representative of its index than an ETF that uses a replication approach.

Derivatives

ETFs can use derivatives to track an index by investing in a derivative (known as a total return swap) whose underlying asset is the index. These ETFs are considered "synthetic" because they use derivatives to create the portfolio as opposed to "physical" ETFs which actually invest in the underlying securities. ETFs may also use derivatives to hedge the currency risk of portfolios that hold foreign securities.

Tracking Error

The most important indicator of an ETF's success at tracking the relevant index is the tracking error. A tracking error occurs when the return of an ETF is not the same as the index.

Example

The market index return is 9.5% for a given period. The index ETF return is 9.3% in the same period. There is a tracking error because the ETF's return trails that of the index.

The tracking error is measured as the standard deviation of the difference in returns between the ETF and the index over a given time frame. Tracking errors are usually calculated by a third party data provider such as Fundata, Morningstar, or Refinitiv.

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The main sources of tracking errors are:

- management fees and expenses
- trading expenses
- cash drag
- securities lending

Trading on the Exchanges and Listed Markets

ETFs are traded on the stock exchanges and other listed markets (e.g. Alternative Trading Systems or “ATS”). In order to buy or sell ETF units, orders must be placed through the dealer which are routed to the exchange. When a “buy” order is placed, it is filled when the exchange matches it against a sell order from another investor. Similarly, when a “sell” order is placed, it is filled when the exchange matches it with a buy order from another investor.

All participants who trade listed securities in Canada, including ETFs, are subject to the rules and regulations of:

- the stock exchanges
- the Universal Market Integrity Rules ("UMIR")

These rules and regulations are established in order to maintain fair and efficient markets and prescribe the trading practices that are prohibited. The rules for the exchanges can be located on their websites and the UMIR rules can be located on the website for the Canadian Investment Regulatory Organization (CIRO). Summarized below are the cardinal principles for trading listed securities.

Trading Rules	
Rule	**Description**
Client Priority and Preferred Trading Rule	• market participants must ensure that the orders of clients will rank ahead of those for industry market participants • orders for the accounts of market participants, including dealers and Dealing Representatives, must be marked "PRO" before they are entered to the exchange so that the exchange will rank them behind client trades • client trades must be filled ahead of "PRO" trades

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Trading Rules	
Rule	**Description**
Best Execution Rule	• market participants must diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under prevailing market conditions • the following factors must be considered: - price - speed of execution - certainty of execution - cost of the transaction

Manipulative Trading Practices

Industry participants are prohibited from engaging in trading practices that are considered "manipulative" under the rules of the stock exchanges and CIRO. Summarized in the table below are manipulative trading practices that are prohibited.

Prohibited Trading Practices	
Item	**Description**
Front-running	• Entering order(s) for a "PRO" ahead of orders for clients to achieve a better price
Scalping	• Undisclosed selling of a security by a market participant while recommending that client(s) buy the same security
High closing	• Causing the last sale/bid/offer for the day to be higher than warranted to manipulate the close price
Sell/Repurchase	• Entering into a scheme to sell and repurchase a security to manipulate the market
Deceiving the public	• Any conduct which deceives the public, buyer, or seller about the nature of a trade or the price of the security
Creating a false or misleading appearance of active public trading	• Creating a false or misleading appearance of active public trading in a security (for example, using fictitious trades)
Manipulating the market price	• Using a manipulative or deceptive scheme to influence the market price of a security

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Buying and Selling ETFs

Dealing Representatives must exercise a great deal of attention to detail when placing orders for ETFs. Errors made when trading on the exchanges, such as the wrong stock symbol, quantity, or price, will have significant ramifications. Orders can be filled within milliseconds on the exchanges. There is no time to correct errors before orders are filled. Errors can result in market losses which can be significant, the costs of which will be borne by the Dealing Representative/dealer. Dealers who allow their Dealing Representatives to offer ETFs will prescribe the specific proficiencies and training that must be obtained before trading ETFs.

Quotes

When using quote services and exchange websites for ETF quotes, there will be several components to the quote as summarized below.

Quotes	
Stock Symbol	• the symbol used by the exchange to trade the security
Bid	• the best price to currently sell the ETF at - (if filled now, up to the number of lots being bid)
Ask	• the best price to currently buy the ETF at - (if filled now, up to the number of lots being asked)
Last Price	• the price that the ETF last traded at
Market Open	• the price that the ETF first traded at when the exchange opened
Market Close	• the price that the ETF last traded at before the exchange closed

There is always a difference between the best bid and the best ask, called the “spread”. The most liquid ETFs have a spread of less than 0.25% and the average spread for ETFs on major exchanges is around 0.5%. Some use a one cent spread as a general rule, but this can be very different for an ETF with a $5 price compared to an ETF with a $100 price.

The bid-ask spread is an important indicator of an ETF's liquidity. It is one of the things to watch for when deciding whether to invest in an ETF.

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Common Types of Orders

The following table summarizes the most common types of orders used to buy and sell ETFs on the exchanges.

Common Types of Orders	
Order	**Terms**
Market order	**Immediately at the best price available**
Buy	Immediately at the lowest price available
Sell	Immediately at the highest price available
Limit order	**At a price no worse than the limit price (established by the buyer/seller)**
Buy	Limit price is at or lower than the current price
Sell	Limit price is at or higher than the current price
Stop order (also called Stop "Loss" Order)	**Will not be executed until the stock price moves to the stop price (established by the buyer/seller), at which time it becomes a market order**
Buy	Stop price is higher than the current price
Sell	Stop price is lower than the current price
Stop limit order	**Combines a stop order and a limit order**
Buy	Limit price is equal to or higher than the stop price
Sell	Limit price is equal to or lower than the stop price

In addition to the order type, the order term (duration) must also be indicated on all orders entered to an exchange. The most common order terms are summarized in the table below.

Order Duration	
Term (Duration)	**When the trade Expires**
Day order	if not filled by the end of the trading session for that day, the order expires
Good till cancelled (GTC) order	• will remain open and will not expire • must be filled or cancelled
Good till date order	• will remain open unless it is filled, cancelled, or it expires on the indicated expiry date

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Trade Confirmation

Once an ETF trade has been executed on the exchange, a trade confirmation must be sent to the client which includes the following trade details: quantity, description, and price of the ETF, principal or agent transaction, date, stock exchange/market, commission, and name of the dealer and Dealing Representative.

ETF Facts

Similar to the *Fund Facts* for conventional mutual funds, dealers and Dealing Representatives are required to deliver an *ETF Facts* document to investors who purchase ETFs. The *ETF Facts* is a short, investor-friendly disclosure document. The *ETF Facts* must be delivered to the investor no later than midnight on the second business day following the purchase of the ETF.

Comparison: Conventional Mutual Funds and ETFs

ETFs and conventional mutual funds share certain common characteristics. Both are open-end funds, meaning:

- the number of outstanding units varies as the fund issues new units or redeems existing units
- the units are in continuous distribution and the fund issues new units continuously to satisfy demand by investors

There are also important differences between ETFs and conventional mutual funds:

- conventional mutual funds issue and redeem units for cash
- ETFs issue and redeem units in exchange for an in-kind baskets of securities

Summarized below is a comparison of ETFs and conventional mutual funds:

Comparison: ETFs and Conventional Mutual Funds

	ETFs	Mutual Funds
Open-end	Yes	Yes
Creation and redemption of units	In kind	In cash
Exchange listed	Yes	No
Pricing	Determined by market supply and demand, and net asset value per unit (NAVPU)	At net asset value per unit (NAVPU)

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Comparison: ETFs and Conventional Mutual Funds		
	ETFs	**Mutual Funds**
Intra-day trading	Yes	No
Market price premium or discount to net asset value per unit (NAVPU)	Yes Usually small	No Priced at NAVPU
Investing approach	Usually passive, but can be active	Usually active, but can be passive
Portfolio turnover	Usually lower	Usually higher
Trading expense ratio	Lower	Higher
Tax efficiency	Usually higher	Usually lower
Investor Disclosure and Risk Rating	Yes ETF Facts	Yes Fund Facts

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Lesson 5: Alternative Mutual Funds and Hedge Funds

Introduction

Alternative mutual funds, alternative exchange-traded funds, and hedge funds are investment funds that use alternative assets and alternative strategies that go beyond a traditional long-only approach of stocks, bonds, and other conventional investments. It is important for Dealing Representatives to have a good understanding about alternative mutual funds and hedge funds because they are widely available to the public. These investment funds may be offered by your firm, or your clients may inquire about or be invested in these products.

In this lesson you will learn about alternative investments, alternative strategies, alternative mutual funds, and hedge funds.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- provide an overview of alternative investments
- explain alternative strategies including directional, event-driven, and relative value approaches
- describe and explain alternative mutual funds
- describe and explain hedge funds
- compare hedge funds, alternative mutual funds, and conventional mutual funds

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Overview of Alternative Investments

Alternative investments provide the opportunity for investors to diversify their portfolio beyond a traditional mix of stocks, bonds, and other conventional investments. Alternative investments can be generally classified into two broad categories:

- alternative assets
- alternative strategies

Alternative assets consist of physical and real assets that do not trade on the public secondary markets including:

- real estate investments
- infrastructure projects
- commodities
- rare collectibles such as art, fine wine, and jewelry
- private shares in startup companies
- commodity pools
- special-purpose securities, such as:
    - real estate investment trusts (REITs) that own commercial property
    - fixed-income securities issued by businesses that are established to own, develop, and manage infrastructure assets
    - units of special-purpose funds that invest in infrastructure projects, such as port facilities and airports

Alternative strategies are sophisticated strategies that go beyond a simple long position of stocks, bonds, or other conventional assets. When an investment fund uses a long only strategy, they buy the security at a lower price, wait for the price to rise, and then sell the security at a higher price. The investment fund nets a gain from the difference in the buy price (lower) and the sell price (higher). The shortcoming of holding long positions is that the portfolio is subject to the volatility of the markets. Long-only strategies are said to have “high” market correlation. The portfolio will benefit from performance that is positively correlated with rising markets but will suffer when markets decline.

Alternative strategies use different investing approaches such as short-selling. Short-selling involves an investment fund that sells a stock that they do not own (the seller). The seller will short-sell the stock with the expectation that the stock price will drop. When the stock price drops, the short-seller will buy the stock on the market for less than they sold it for, thus making a profit from the difference in the price. When the stock is sold short, in order to deliver the stock to the buyer, the short-seller will borrow it from (or through) an

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investment dealer. When the stock is bought, the short-seller will give the stock to the investment dealer to "cover" the short position.

Example

The Pythia Alternative Strategies Fund believes that the stock price of Goldblind Inc. is about to drop dramatically because the company's exploration efforts are going nowhere. The fund decides to sell 10,000 shares short at the current price of $50 per share.

Six months later, the stock price drops to $45. The Pythia Fund covers its short position and makes a profit of $50,000 in the process.

Proceeds of short sale (10,000 shares x $50)	$ 500,000
Less: Purchase price (10,000 shares x $45)	$ 450,000
Profit	$ 50,000

Alternative mutual funds, alternative exchange-traded funds (ETFs), and hedge funds use alternative strategies including short-selling, leverage, and the use of derivatives, and have fewer restrictions with respect to liquidity and foreign currency exposure. These alternative strategies can have "low" market correlation. Funds with low correlation have the potential to earn profits regardless of if markets are going up, going down, or staying the same.

While low market correlation can increase diversification and reduce correlation risk, it is also important to recognize the higher risks of alternative strategies related to liquidity risk and risks from exposure to derivatives, leverage, and short-selling.

Alternative Investment Strategies

Alternative investment strategies can be broadly classified into three types, namely directional strategies, event-driven strategies, and relative value strategies. The strategy type describes the overall approach that the portfolio manager takes to achieve the fund's stated objectives.

Alternative Investment Strategies

Type	Objective	Market Correlation	Strategies
Directional	• seeks to profit from the ability to select securities by predicting whether they will outperform or underperform the market	High	• Long-Short Equity • Managed Futures • Global Macro

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Alternative Investment Strategies			
Event-Driven	• strives to take advantage of the expected stock price discrepancy that may occur either before or after a corporate event (e.g. stock repurchases, stock splits, mergers, acquisitions)	Medium	• Merger or Risk Arbitrage • Distressed Securities • Non-Traditional Bonds
Relative Value	• seeks to profit from the difference in the price of similar or related securities (i.e. arbitrage)	Low to Negative	• Equity Market Neutral • Convertible Arbitrage • Fixed Income Arbitrage

Summarized below are the most common directional, event-driven, and relative value alternative strategies.

Directional Strategies	
"High" Market Correlation	
Long-Short Equity	• buys equities (long positions) expected to outperform • sells short equities (short positions) expected to underperform
Managed Futures	• actively managed portfolio of derivatives contracts • can include futures, options, and/or swap contracts • seeks to profit from long or short positions taken to benefit from perceived mispricing of specific assets represented in the futures markets such as commodities, bonds, currencies, and stock indices
Global Macro	• seeks to profit from a future event that will affect entire economies (e.g. shift in government policy related to interest rates, currencies, commodities, etc.)

Event-Driven Strategies	
"Medium" Market Correlation	
Merger or Risk Arbitrage	• takes long and short positions of stocks or bonds that are involved in a proposed merger or acquisition - takes a long position in the target company - takes short position in the acquiring company

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Event-Driven Strategies	
"Medium" Market Correlation	
Distressed Securities	• invests in the equity or debt of companies that are considered to be in distress • invests when the price is heavily discounted
Non-Traditional Bond	• invests in non-traditional bonds including emerging market debt, mortgage-backed securities, and high-yield bonds • can also be called credit focused or long-short credit focused strategy

Relative Value Strategies	
"Low to Negative" Market Correlation	
Equity Market Neutral	• seeks positive returns regardless of whether the overall market rises or declines • takes equivalent long and short positions in closely related securities
Convertible Arbitrage	• seeks to profit from pricing inefficiencies that may exist between a convertible security and the underlying equity • takes a long position in the convertible security and a short position in the underlying common stock
Fixed Income Arbitrage	• seeks to profit regardless of the performance of bond markets • assumes opposing positions in the market to take advantage of small discrepancies

For Canadian investors, alternative assets and strategies can be accessed by investing in alternative mutual funds, exchange-traded funds, closed-end funds, hedge funds, and structured products such as principal protected notes. Exactly which of these investment options will be available to you will depend on your firm's policies, procedures, and Approved Products List.

Alternative Mutual Funds

Alternative mutual funds are investment funds that employ alternative strategies and investments. ETFs that use alternative strategies are considered alternative mutual funds under National Instrument (NI) 81-102. Alternative mutual funds may invest in alternative asset classes such as real estate and infrastructure assets, or other physical assets and commodity exposures not generally permitted in conventional mutual funds.

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Alternative mutual funds are also permitted to use a wider range of strategies using derivatives, short-selling, and leverage.

Alternative mutual funds are different than hedge funds in that they are subject to the requirements under National Instrument (NI) 81-102. As such, alternative mutual funds are:

- redeemable
- subject to all of the reporting and disclosure requirements for conventional mutual funds
- afforded the statutory right of rescission and right of withdrawal

While some of the alternative strategies employed by alternative mutual funds are similar to those used by hedge funds, they are subject to restrictions and limitations imposed under NI 81-102 including those related to:

- liquidity (alternative mutual funds are redeemable, unlike hedge funds)
- transparency in reporting (i.e. prospectus and continuous disclosure)

Liquidity

Alternative mutual funds are subject to the requirements under NI 81-102 that:

- restrict borrowing and debt
- impose limits on illiquid investments
- require the fund to allow investors to sell units at any time
- support the liquidity requirements dictated by the fund's redemption feature needs

Like conventional mutual funds, alternative mutual funds offer daily liquidity, a key distinction from the more limited liquidity of hedge funds.

Transparency

Unlike hedge funds, alternative mutual funds provide the same level of transparency as conventional mutual funds. This includes the requirement to offer the fund by prospectus, issue monthly security-holding reports, and provide quarterly fund reports to investors.

Hedge Funds

Hedge funds are "exempt" securities offered under exemptions from prospectus requirements. Unlike alternative mutual funds, hedge funds can invest in any type of alternative investment or strategy and are not

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subject to restrictions. Hedge funds can employ more complex strategies such as concentrated positions and arbitrage transactions. These features differentiate hedge funds from alternative mutual funds and exchange-traded funds (ETFs).

Hedge funds derive their name from the term “hedging”, a risk management strategy utilized in investing for the purpose of offsetting losses. While hedge funds can be used effectively to manage or even reduce risk this way, some funds do not hedge their positions at all, and others are specifically designed to achieve returns from speculation.

With their more flexible structures and ability to use more complex investment strategies, hedge funds can offer potential benefits that are not available through alternative mutual funds and ETFs. However, hedge funds have additional risks because they are exempt securities and are not subject to the requirements imposed on prospectus issuers. Hedge fund investors are not afforded the same legal rights that are available to investors who purchase prospectus-based investments.

Since hedge funds are exempt securities, they may only be offered to accredited and eligible investors who must qualify to subscribe for the hedge fund offering. Subscription minimums for hedge funds are often higher than those of traditional mutual funds.

Dealing Representatives who are permitted to offer hedge funds will be required to ensure that investors qualify as an accredited or eligible investor before they invest. This obligation must be satisfied in addition to the Know Your Client, Know Your Product, and suitability obligations. Firms that offer hedge funds will prescribe strict guidelines, policies, and procedures for Dealing Representatives to follow to:

- qualify investors for exemption
- collect the required documentation for exempt securities including the breakdown of assets, subscription forms, accredited/eligible investor certificates, and signed *Risk Acknowledgements*

Liquidity

Hedge funds are less liquid than mutual funds and alternative mutual funds because they are traded and priced less frequently. Where mutual funds post a net asset value per unit (NAVPU) daily, hedge funds are typically priced weekly or monthly. This means that money can only be added to or taken from the fund at that time, thus making hedge funds less liquid. In addition, many hedge funds have a monthly subscription and quarterly redemption period which require 30-day notice for redemptions, thus reducing liquidity.

Some hedge funds invest in illiquid assets which means that the initial investment is locked up and cannot be redeemed for a period of time, frequently one or two years. In some instances, the lock-up period means that the investor cannot redeem their investments for any reason, while in other instances the investor can redeem their investments before the end of the lock-up term if they pay a fee. Regardless of lock-up provisions and notice periods, hedge funds can often suspend redemptions entirely, thus making liquidity questionable and precarious.

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Transparency

While mutual funds and alternative mutual funds are distributed by prospectus and are subject to the continuous disclosure requirements of public issuers, hedge funds are not subject to the reporting issuer regime, they provide less information to their investors, and the information provided is not subject to the oversight of the regulators. Not every hedge fund will reveal their portfolio. This lack of transparency often makes it difficult to ascertain whether the hedge fund is actually doing what it says it will do (i.e. whether it is adhering to its investment mandate, risk control process, trading discipline, and/or compliance processes).

Incentive fees

The use of incentive fees, also known as performance fees, is a common feature of hedge funds. In addition to management and administration fees, hedge fund managers usually charge an incentive fee based on the fund's performance.

Comparison: Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds

The chart below summarizes the key features of conventional mutual funds, alternative mutual funds, and hedge funds to illustrate the main differences, allowable strategies, and restrictions across the funds.

Comparison:

Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds

	Hedge Funds	Alternative Mutual Funds	Conventional Mutual Funds
Concentration Limits	• Unlimited per regulatory requirements (limits may be established in the Offering Documents)	• Up to a maximum of 20% of the net asset value (NAV) may be invested in securities of any single issuer	• Up to maximum of 10% of the net asset value (NAV) may be invested in securities of any single issuer
Short-Selling:	• 100% of NAV (limits may be established in the Offering Documents)	• Up to 50% of NAV, with single issuer limited to 10% of NAV (government securities excluded) • No cash cover required	• Up to 20% of NAV, with single issuer limited to 5% of NAV • 150% cash cover required in all cases

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Comparison:
Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds

	Hedge Funds	Alternative Mutual Funds	Conventional Mutual Funds
Borrowing	• Unlimited	• Up to 50% of the NAV	• Not permitted
Use of Leverage	• Unlimited use	• Up to 300% of NAV (gross aggregate exposure)	• None
Derivatives*			
• Restrictions -Trade in Only Cleared Specific Derivatives	• Not restricted (unless established in the Offering Documents)	• Not restricted	• Restricted
• Restrictions - Deal only with Over-the-Counter derivative counterparties with approved credit rating	• Not restricted (unless established in the Offering Documents)	• Exempted from this restriction	• Restricted
• OTC derivative single counterparty exposure	• Not restricted (unless established in the Offering Documents)	• No more than 10% of NAV fund exposure to any one OTC derivative counterparty	• No more than 10% of NAV fund exposure to any one OTC derivative counterparty
Physical Commodities	• Unlimited per regulatory requirements (limits may be established in the Offering Documents)	• Up to 10% of the fund's NAV (without exemption): - directly into gold, silver, palladium or platinum (precious metal) commodities; or - indirectly through specific derivatives	• Precious metal certificates (that do not include silver, gold, platinum or palladium) • Physical commodities (other than up to 10% in silver, gold, palladium platinum)

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Comparison: Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds			
	Hedge Funds	**Alternative Mutual Funds**	**Conventional Mutual Funds**
Investments in Illiquid Securities	• Unlimited per regulatory requirements (limits may be established in the Offering Documents)	• Limited investing in illiquid assets: • Up to 10% of fund NAV when purchased • Up to 15% of NAV of fund for 90 days or more	• Limited investing in illiquid assets: • Up to 10% of fund NAV when purchased • Up to 15% of NAV of fund for 90 days or more
Redemption Features			
• Product Redemption	• Weekly, monthly; (at times, quarterly)	• Daily	• Daily
• Initial Redemption Deferral	• As per definition in Offering Documents (typically 30 days but can be a longer exception)	• Permitted up to six months after date on which receipt issued for initial prospectus (must be disclosed in prospectus in that case)	• Generally, no redemption deferral period (prospectus permits exception by the manager in certain market conditions)
Fees			
• Management Fees	• No restrictions per regulatory requirements (as established in the Offering Documents)	• Permitted	• Permitted
• Performance Fees	• Permitted (normally based on the total return of fund)	• Permitted; however, performance fees normally based on cumulative total of fund return for the period beginning immediately after last period for which fee was paid	• Permitted; however, only performance fee(s) tied to benchmark or index can be charged

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Comparison:
Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds

	Hedge Funds	Alternative Mutual Funds	Conventional Mutual Funds
Commissions	• As per the Offering Documents	• As permitted by National Instrument (NI) 81-105 Mutual Fund Sales Practices • Sales commissions cannot be charged to fund	• As permitted by National Instrument (NI) 81-105 Mutual Fund Sales Practices • Sales commissions cannot be charged to fund
Offering Documents	• Usually by way of Offering Memorandum	• Not listed on an exchange: - Simplified prospectus - Fund Facts • Exchange-Traded Funds: - Long prospectus - ETF Facts	• Not listed on an exchange: - Simplified prospectus - Fund Facts • Exchange-Traded Funds: - Long prospectus - ETF Facts
Disclosure Requirements (Transparency)	• Not subject to continuous disclosure under regulatory requirements • As per the Offering Documents, typically annually or semi-annually	• Monthly: Top 10 security holdings • Quarterly portfolio disclosure • Annual and interim financial disclosure	• Monthly: Top 10 security holdings • Quarterly portfolio disclosure • Annual and interim financial disclosure

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Comparison: Conventional Mutual Funds, Alternative Mutual Funds, and Hedge Funds			
	Hedge Funds	**Alternative Mutual Funds**	**Conventional Mutual Funds**
Right of Withdrawal	• No right of withdrawal under regulatory requirements (exception may be stated in the Offering Documents)	• Right to cancel within 48 hours of receipt of purchase	• Right to cancel within 48 hours of receipt of purchase
Regulatory Requirements	National Instrument (NI) 45-106, Prospectus Exemptions	• National Instrument (NI) 81-102, Investment Funds • National Instrument (NI) 81-105, Mutual Fund Sales Practices	• National Instrument (NI) 81-102, Investment Funds • National Instrument (NI) 81-105, Mutual Fund Sales Practices

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Lesson 6: Other Investment Products and Investment Funds

Introduction

There are several investment options available in the financial market. This lesson covers investment products such as principal protected notes, pooled funds, income trusts, and segregated funds. Some of these products have similar features to the investment funds discussed in this unit. It is important to note that you may require additional proficiency or registration/licensing to provide advice on some these products. Check with your dealer before proceeding.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to describe the following:

- describe the major characteristics of principal protected notes
- describe the concept of pooled funds
- describe the concept of income trusts
- describe the major characteristics of segregated funds

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Understanding Other Investment Products and Investment Funds

In addition to having knowledge about the investment funds discussed so far, you should have a basic understanding of some of the other investment products available to the public. These investment products may be offered by your firm, or your clients may inquire about or be invested in these products. It is important to understand that some of these products may not be subject to the same level of disclosure, transparency, or reporting requirements as mutual funds. Since access to reliable, accurate, or up-to-date information may be limited, some of these products may be considered higher risk.

Additional requirements may also be imposed by your dealer or the regulators for these products. For instance, clients may be required to qualify as an eligible investor or an accredited investor in order to invest. Your dealer may also impose concentration restrictions or additional proficiency/licensing may be required (e.g. segregated funds).

Before providing any advice on these products, be sure to check with your dealer.

Principal Protected Notes (PPNs)

Principal protected notes (PPNs) are structured products offered by financial institutions that provide two main features:

- the repayment of the original principal upon maturity
- the opportunity to participate in returns linked to an index/benchmark

PPNs derive their return from a combination of different investment vehicles, expressed as the net asset value (NAV) of the note. The guarantor of the PPN, a Schedule I or II bank, guarantees that they will repay the principal amount at maturity. The PPN also offers the opportunity to share in the returns from the underlying assets (minus fees), which commonly include hedge funds but may also include common shares, market indices, options, or commodities. This allows retail investors to gain access to assets such as hedge funds without qualifying for exemptions as eligible or accredited investors. The return from the underlying asset is normally only available if the PPN is held until maturity.

While PPNs provide the opportunity to participate in the returns of the underlying asset, the returns are not guaranteed. Where returns on the underlying asset do not materialize or are negative, the investor will only receive their principal back. Many PPNs also have features built into the product which protect the issuer from exposure to market volatility, commonly referred to as a “knock-out” feature. Where the net asset value of the PPN hits a certain value trigger, a "protection event" occurs and the PPN is reallocated so that it no longer has exposure to the underlying asset(s). In such circumstances, the investor loses the ability to earn any returns over their principal amount. At maturity, the investor will only receive the original amount they invested.

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Example

Carrie invests in a PPN which is repayable in 7 years and linked to the S&P/TSX Composite Index. At maturity, Carrie will receive a return equal to a portion of the positive return, if any, of the S&P/TSX Composite Index over the term of the note. If the return of the index over the period is flat or negative, she will only receive her original principal back.

Principal protected notes are designed to be held until maturity and the terms are often 4 to 8 years. The lack of a secondary market, and the lock-up periods, notice periods, and early redemption penalties inherent with PPNs make them illiquid investments. Since the issuer is not obligated to effect redemptions, PPNs have poor liquidity.

PPNs come with the following fees/costs:

- sales commissions
- early redemption fees
- management fees
- performance fees
- structuring fees
- operating fees
- trailer fees
- swap arrangement fees

Pooled Funds

Pooled funds and mutual funds share many similarities. They both pool together investor money, are structured as unit trusts, have professional portfolio managers to make investment decisions, offer a variety of investment options, and provide liquidity through redemptions.

However, pooled funds have some distinct differences:

- they are not required to file prospectuses with the provincial securities commissions
- they are only available to eligible or accredited investors (i.e. sophisticated and high-net-worth investors)
- they have high minimum investment requirements
- they benefit from economies of scale which lowers the management fees

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Income Trusts

Income trusts are trusts that invest exclusively in one or more operating companies, with the objective of distributing cash flow to their investors (unitholders). Unitholders have a right to the income and capital of the trust. The underlying operating company usually has a consistent cash flow of interest, royalties, or lease payments and these are passed along to unitholders. The units are traded on the stock exchanges.

Prior to 2006, income trusts were very popular because of their favourable tax treatment. They were not subject to corporate tax. However, since that time, the Federal government now requires all income trusts to pay corporate tax before any distributions are made.

Segregated Funds

Segregated funds are investment funds offered under the life insurance industry. They are variable annuities, which are investment products offered through life insurers that can only be sold by licensed life agents. The technical term for a segregated fund is individual variable insurance contract (IVIC). The value of the contract is linked to that of an underlying investment fund selected by the investor. The insurer may hedge its investment risk by investing the proceeds of sale of the segregated fund in units of the underlying fund.

Segregated funds have some key distinctions from mutual funds:

- Investors do not own the units of the underlying fund. Instead, investors own an insurance contract whose value is linked to that of the underlying fund. The insurer owns the units of the underlying fund.
- In addition to interest, dividends, and capital gains, segregated funds can flow capital losses to investors.
- Segregated funds guarantee the return of at least 75% (sometimes 100%) of the capital invested to the investor at maturity of the contract (usually ten years) or death of the contract holder. Redemption of the segregated fund at any other time is subject to the current market value.
- Some segregated funds allow investors to reset the principal amount at periodic intervals. Resets lock in increases in the value of the segregated fund.
- Segregated funds charge higher management fees to cover the cost of the guarantees.
- Investors can designate a beneficiary to the contract.
- Investor monies may be protected from creditors.

These funds are suited for investors who want the benefit of investing in the equity market, but also want some protection of their principal from market volatility.

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Summary

Congratulations, you have reached the end of Unit 6: Types of Investment Funds.

In this unit you covered:

- Lesson 1: Introduction to Investment Funds
- Lesson 2: Investment Fund Categories
- Lesson 3: Features and Objectives of Fund Types
- Lesson 4: Exchange-Traded Funds
- Lesson 5: Alternative Mutual Funds and Hedge Funds
- Lesson 6: Other Investment Products and Investment Funds

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 6 **Quiz** button.

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Unit 7: Portfolio Management

Introduction

A portfolio is the collection of securities held in an investment fund. As a Dealing Representative it is very important that you have a good understanding of the approaches and methodologies used in selecting and managing the investments within an investment fund portfolio.

In this unit you will learn about different investment styles and investment management strategies. You will also learn about financial analysis, as well as investment fund performance, investment fund risk, and the relationship between performance and risk.

This unit takes approximately 1 hour and 15 minutes to complete.

Lessons in this unit:

- Lesson 1: The Portfolio Manager
- Lesson 2: Financial Analysis
- Lesson 3: Investment Fund Performance and Risk

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Lesson 1: The Portfolio Manager

Introduction

A portfolio is a collection of securities held in an investment fund. Portfolio management refers to the science of creating and managing a portfolio in order to achieve a specific investment goal.

In this lesson you will learn about the role of a portfolio manager, and the different approaches and methodologies that portfolio managers use to select and manage an investment fund's investments.

This lesson takes approximately 25 minutes to complete.

At the end of this lesson, you will be able to:

- describe the role of the portfolio manager
- explain the difference between active and passive portfolio management
- differentiate between top-down and bottom-up investing
- describe the three major investment styles (value, growth, and growth at a reasonable price)
- explain the difference between technical and fundamental analysis
- discuss modern portfolio theory and the efficient frontier

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Role of the Portfolio Manager

One of the advantages of investment funds is that investors can take advantage of the services of professional money managers. Each investment fund has specific investment objectives as laid out in the simplified prospectus. It is the responsibility of the portfolio manager(s) to ensure that those objectives are met. Their goal is to attain the highest return possible while complying with the stated investment objectives and risk constraints of the investment fund.

The portfolio manager selects the securities held in an investment fund. Some investment funds have a single portfolio manager while others use a team approach. They may be employees of the investment fund manager or an outside entity that specializes in portfolio management. Some investment fund managers have in-house portfolio managers for their Canadian funds, while using outside specialists for foreign investment funds, which require familiarity with those markets.

Investors can receive updates on the most recent investment decisions and actions taken by the portfolio manager in the investment fund's commentary or Management Report and Fund Performance (MRFP).

Portfolio Manager Qualifications

Portfolio managers are required to be registered with the provincial securities commissions in the provinces in which they choose to operate. Registration is only granted to individuals who satisfy certain educational and experience requirements as specified in National Instrument 31-103.

In terms of education, portfolio managers must obtain an approved designation such as the Chartered Financial Analyst® (CFA)® designation, which is bestowed by the CFA Institute. The Charter is granted to those who have completed an intensive course of study, passed a series of rigorous exams, and fulfilled a work experience requirement.

In addition, regulators require portfolio managers to have relevant investment management experience. They must show that they have performed portfolio management duties for a minimum length of time.

Investment Management Strategies

There are two general strategies for investment funds:

- passive portfolio management
- active portfolio management

Knowing whether a portfolio manager uses an active or passive strategy can help you manage your client's expectations. The investment strategy of an investment fund is typically described in the simplified prospectus under the fund's Investment Strategies section.

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Passive Portfolio Management

Portfolio managers that use a passive portfolio management strategy choose securities according to a specific benchmark. The benchmark represents a specific market, such as a stock index (e.g. S&P/TSX composite index). It is often used as a peer group standard to measure the performance of an investment. Passive portfolio managers do not intend to outperform the benchmark. Rather, their goal is to replicate, or track, the return of that benchmark as closely as possible. They can achieve this by either purchasing the exact same securities in the same proportion as the index, purchasing a sample of those securities, or by using derivatives.

A passive investment strategy greatly reduces the amount of trading within an investment fund. Once the initial investments are made, no further trades are usually required unless the make-up of the underlying benchmark changes. This results in lower transaction costs, which translates to lower management expense ratios (MERs) for passively managed funds when compared to actively managed funds.

The passive investment strategy is based on the Efficient Market Hypothesis (EMH) theory. The theory states that market prices of securities already reflect all publicly available information. This being the case, it would be futile for anyone to attempt finding mis-priced securities (i.e. securities that are not fairly priced) that may provide a higher return.

For instance, some practitioners of passive portfolio management believe that securities of large U.S. companies are fairly priced. Large U.S. companies are closely followed by analysts and financial journalists. Any information that is related to their value is likely to be reported and disseminated to the public, at which point the market price of the security will quickly adjust to reflect the new information.

Passive Portfolio Management Considerations

A passively managed fund is required to mirror the performance of a market index. Therefore, it will be exposed to all of the ups and downs of the market index. When the market index performs well, the passive investment fund will benefit. Of course, the return of the investment fund will be slightly less from the management fees and any discrepancies between the actual portfolio and the underlying market index.

There is a risk associated with passive investments. If the market index drops, the passive investment fund will suffer. In this situation, the portfolio manager is unable to protect against the downside risk of the market index since they only adjust the portfolio when there is a change to the benchmark. This limitation also affects the portfolio manager's ability to take profits by selling securities that perform well in their portfolios. They are not able to capture these gains when they occur.

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Example

Susan invests in an index fund that tracks the Standard & Poor's (S&P)/Toronto Stock Exchange (TSX) Composite Index. The index fund holds the same securities as those listed in the S&P/TSX Composite Index. Susan benefits from the low management expense ratio of 0.30% charged by the investment fund. In the first year, the S&P/TSX Composite Index returns 5.5%. Susan's index fund returns 5.2%.

The following year, the S&P/TSX Composite Index falls by -10.4% and Susan's investment fund also drops but by -10.7%. The portfolio manager is prevented from making any defensive move to protect investors like shifting the portfolio to cash.

Susan will experience all the ups and downs of the benchmark with her index fund.

Active Portfolio Management

In contrast to passive portfolio management, active portfolio management is based on the idea that not all information about securities is widely known. Hence, there are opportunities to discover securities that are not properly priced because of this market inefficiency. Practitioners of active portfolio management believe that through their skill in research and analysis they can find these securities. By relying on their abilities to pick securities and construct a portfolio, active portfolio managers attempt to outperform the benchmark.

For instance, an active portfolio manager may discover through research and analysis that a large U.S. company has a competitive advantage over its peers in making products at lower cost, which will increase the company's earnings and security value over time. This information about the company is not commonly known, nor is it yet reflected in the security's current market price. The portfolio manager sees an opportunity for higher returns by investing in this security, which the portfolio manager believes is mis-priced, compared to one that is already fairly priced.

An active portfolio management strategy has the flexibility to select securities as long as they are aligned with the investment mandate of the investment fund.

Example

Cheri invests in an actively managed Canadian equity fund that is compared to the S&P/TSX Composite Index. In the first year, the portfolio manager finds opportunities in the resource and retail sectors and begins to choose securities in these industries. He also decides that a couple of the holdings in the investment fund are underperforming; he sells those and re-allocates the cash to other investments. The S&P/TSX Composite Index returns 5.5%. Cheri's investment fund returns 9.8%.

The following year, the portfolio manager takes profit in some of his holdings and begins to hold cash in the portfolio as a defensive move. The S&P/TSX Composite Index falls by -10.4% but Cheri's investment fund only drops by -7.2%.

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Active Portfolio Management Considerations

The fact that active portfolio managers select the securities in an investment fund has its advantages and disadvantages. Since active managers control their transactions, they decide what to buy or sell and when. This flexibility allows them to seize new investment opportunities when they arise and realize profits at favourable times. They are not restricted by the market index. Alternatively, they can adopt defensive strategies to protect the portfolio from market downturns. The risk of being able to pick and change the securities of the investment fund is that the portfolio manager may select a poorly performing security or miss an investment opportunity.

Due to an increased amount of trading, actively managed funds incur more transaction costs than those that are passively managed. Their management expense ratios (MERs) are also higher since there is a cost to the portfolio manager performing research and analysis. However, many feel that if the fund is outperforming its benchmark, these costs are acceptable in exchange for higher returns.

Active Management Approaches

Active portfolio managers generally use one of two approaches to select securities for their investment funds:

- top-down
- bottom-up

Top-Down Approach

The top-down approach begins with looking at the overall economy and current market trends to determine the industries, markets and/or countries that are expected to perform well. Portfolio managers look at macroeconomic variables such as the Gross Domestic Product (GDP) of various countries, interest rates and employment rates. From there, they narrow down their search by identifying the industry, sector, or countries that look favourable considering the economic conditions. Finally, they select companies that they feel have the most potential and meet the investment fund's investment objectives.

Example

Donna is a portfolio manager for Bedrock International Growth Fund. She employs a top-down investment strategy to pick securities for the investment fund. She begins by looking at the overall health of various countries around the world, studying data such as gross national product (GNP), unemployment, and inflation. Donna decides that the German economy seems quite robust and has good growth prospects. Having decided that Germany will be her target economy, Donna next looks at the various industry sectors in Germany. As a result of her research, Donna decides that the strongest economic sectors are banking and steel.

Finally, she analyzes the various companies in the banking and steel sectors and decides that Commerzbank and ArcelorMittal are the best prospects in their respective industry sectors. She decides to make investments in both of these companies.

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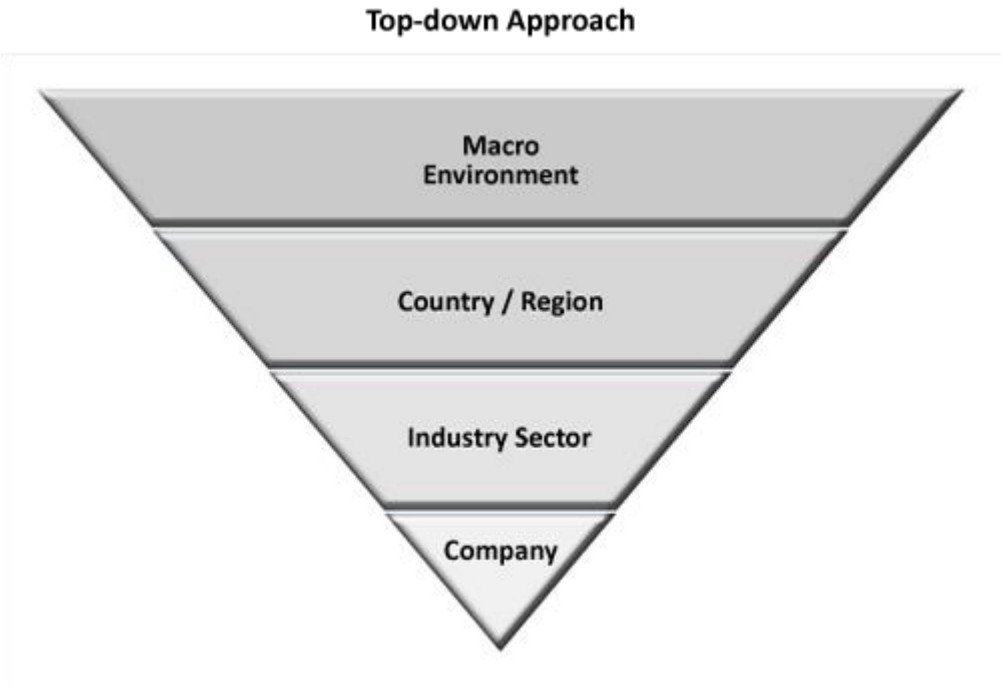

Bottom-Up Approach

Portfolio managers that take the bottom-up approach focus on individual companies, the economy and market cycles are secondary considerations. They believe good companies can succeed even if a particular industry, country, or region is struggling. Part of the portfolio managers' investment process includes reviewing a company's business prospects, meeting with its management team, and evaluating its financial statements.

Example

Jenny manages the European Value Fund with a bottom-up approach. She starts by looking for companies with good prospects. From her research, Jenny identifies two excellent prospects: Kredietbank, a Belgian financial company, and Peroni Company, an Italian brewing concern.

Although the Belgian and Italian economies may not be the strongest in Europe, Jenny decides that the prospects for these companies are very good and the management is solid. Therefore, she decides to make investments in each of these companies.

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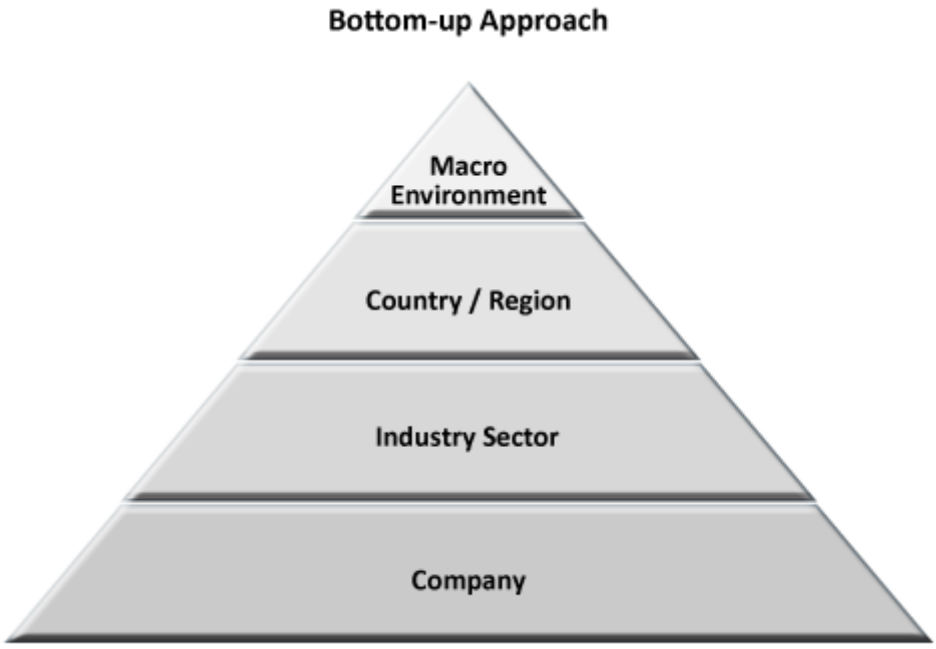

Investment Styles

Investment styles impact how portfolio managers make their trade decisions. The following are the basic investment styles.

Investment Style	Description
Growth	This style of investing looks for securities of companies with above-average growth potential than their peers. Growth securities are often represented by growing or expanding companies. Growth managers believe that growth in a company's earnings or revenues will directly correlate to an increase in the share price. As a result, they are willing to pay a higher price for these securities as long as there is growth potential.
Value	Value style investing looks for securities of good-quality companies that are undervalued. Securities may be undervalued because the sector or company has experienced some bad news or is currently out of favour. Value managers decide what they believe a company's shares are worth (its intrinsic value) and then compare it to how it is actually trading. If it is trading below intrinsic value, it is a bargain and the value manager will buy them. Value managers believe that the market is either unaware of a company's true value or has beaten the price down unfairly. When the share price corrects, the value manager will profit.

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Investment Style	Description
Growth at a Reasonable Price (GARP)	Growth at a Reasonable Price (GARP) combines the principles of growth and value investing, while avoiding the extremes of either approach. GARP managers seek investments with a consistent above-average earnings record, and potential for continued growth in the future. GARP managers will purchase these growth investments at prices that are lower than their industry peers, but not at the bargain prices that value managers seek.

Investment Selection Methodology

Technical and fundamental analyses are the two types of security selection methodologies that portfolio managers use for finding and analyzing securities.

Technical Analysis

Technical analysis is a method of evaluating securities based on studying past trends in market activity, prices, and volume.

Technical analysts look for patterns or indicators to predict future price movements. Technical analysts are often referred to as chartists since they rely heavily on charts of share-price behaviour and trading volume to make their extrapolations.

Fundamental Analysis

Fundamental analysis involves looking at the fundamentals of a company such as revenues, assets, profits, and competitive position. Fundamental analysts study a company's financial statements, may speak with its management, customers and suppliers, and consider macroeconomic factors such as the economy, inflation and the interest rates that could impact a company’s earning potential. They attempt to predict the future prospects of a company by becoming intimately acquainted with the details of the company.

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Modern Portfolio Theory

Although the concept of diversification has been around for a long time, it was the introduction of the Modern Portfolio Theory that really brought this concept into the forefront of the investment world. Modern portfolio theory explains the benefits of taking a portfolio approach to investments rather than focusing on single investments. Accordingly, investments should not be evaluated only on their own characteristics, but also in relation to other types of investments. If investors diversify their portfolio, they can effectively reduce the overall risk within their portfolios and enhance their potential return.

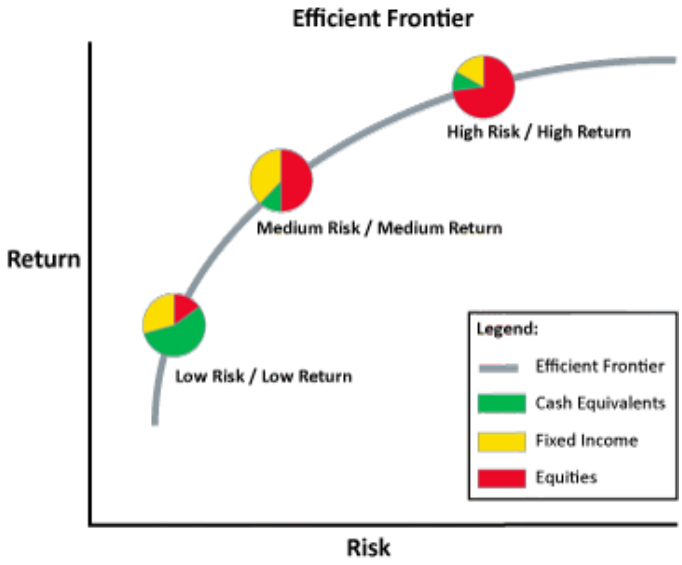
Modern portfolio theory provides a mathematical framework for constructing a diversified portfolio. For instance, bonds and equities generally do not perform similarly. In addition, various types of risks affect them differently. Considering their dissimilarities, combining bonds with equities can help reduce the overall volatility of the portfolio, thereby protecting the portfolio from suffering large losses.

Efficient Frontier

Since Modern Portfolio Theory provides a mathematical approach to portfolio construction, it then becomes possible to determine the optimal portfolio.

The optimal portfolio is one that provides the highest return given a particular level of risk. Because investors have different risk levels, there are a multitude of optimal or efficient portfolios. These optimal portfolios can be plotted on a graph called the efficient frontier.

All portfolios on the efficient frontier provide the highest return for a given amount of risk. Portfolios that are below the frontier are considered inefficient and inferior because they either offer portfolios with the same return but at a higher risk, or they offer lower return for the same level of risk.



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Lesson 2: Financial Analysis

Introduction

Financial analysis enables portfolio managers to gauge the past and current performance of companies, in order to assess the value and potential future performance of companies and their securities.

In this lesson you will learn about financial statements and financial analysis ratios that portfolio managers use in determining which investments to include in an investment fund portfolio.

This lesson takes approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- describe the main types of financial statements that portfolio managers use to analyze securities:
  - Balance Sheet
  - Income Statement
  - Cash Flow Statement
  - Statement of Retained Earnings

- describe the common types of ratios that portfolio managers use in assessing the value of securities:
  - Profitability
  - Liquidity
  - Debt-equity
  - Valuation

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Financial Statements

Companies that make their securities available to the public are required to publish audited financial statements on an annual basis. Annual financial statements must be reviewed by an independent auditor or auditing firm to ensure that they comply with accounting standards (Canada has adopted International Financial Reporting Standards (IFRS)). Interim reports are usually published quarterly or semi-annually but are not required to be audited.

These statements are the primary source of information for a fundamental analyst. A company's financial statements provide information about its past, current, and future business performance. Through the analysis of financial statements, portfolio managers can evaluate the value of a company and its securities.

The primary financial statements used to evaluate a company include the following:

- balance sheet
- income statement
- cash flow statement
- statement of retained earnings

Balance Sheet

The balance sheet is often defined as a snapshot of a company's financial position at a specific point in time. Sometimes referred to as statement of financial position or statement of assets and liabilities, it provides valuable information about what a company owns and what it owes.

There are three components to a balance sheet displayed as follows:

Assets This is what a company owns and what it is owed. Assets include: • current assets (e.g. cash, marketable securities, accounts receivables, inventories) • fixed assets (e.g. buildings, properties, equipment) • intangible assets (e.g. goodwill, patents)	=	**Liabilities** This is what a company owes its creditors. Liabilities include: • current liabilities (e.g. accounts payable, accrued expenses, short-term debt) • long-term liabilities (e.g. long-term debt) **Shareholder's equity** This is the capital provided by the shareholders (common and preferred shareholders) plus retained earnings of the company.

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The balance sheet derives its name from the fact that both sides of the statement must be equal.

NOTE: In most cases the assets and liabilities are recorded on the balance sheet at their historical value rather than market value. (An exception is an investment fund where the assets or investments are recorded at market value.)

Income Statement

The income statement shows how much revenue a company earned and the expenses it incurred during a specific period. If revenues are greater than expenses, the company shows a profit. If revenues are less than expenses, the company shows a loss.

There are six main sections on an income statement.

Section	Description
Operating Income	These figures show the revenue generated from sales of the company's products and services. The gross sales number is recorded minus any adjustments for returned merchandise, bad debts, rebates to customers, and other discounts.
Operating Expenses	These are the expenses incurred by the company in the process of conducting business. These include such costs as raw materials, employee salaries, rent, and marketing expenses.
Operating Profit (or Loss)	This figure is arrived at by subtracting operating expenses from operating income. This figure shows how much money was made (or lost) from the company's normal business operations.
Other Income (or Losses)	Aside from operations, a company may earn income from other sources, such as investments. These items are usually listed under other income.
Income Taxes	Corporate income taxes are based on the pre-tax profit of a company. The pre-tax profit is calculated by taking a company's operating profit, adding other income, and subtracting interest it pays on bonds. Taxes must be deducted before profits can be reinvested in the company or distributed to shareholders.
Net Profit (or Loss)	This figure, referred to as the bottom line, represents the overall success of the business. It is calculated by subtracting the income tax expense from pre-tax income. Any net profit (or loss) is then added to (or subtracted from) retained earnings on the retained earnings statement.

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Cash Flow Statement

The cash flow statement shows where a company's cash is coming from and how it is being spent. It helps creditors and investors assess whether the company:

- can generate cash when needed
- has the cash to meet its financial obligations
- has enough cash to pay dividends or to reinvest

The cash flow statement is separated into three sections.

Section	Description
Operating Activities	Refers to cash inflows and outflows from the company's daily activities, such as the net income from the sale of its products and services.
Investing Activities	Includes cash expenditures for the purchase of assets or cash receipts through the sale of assets as well as income from investments, such as interest or dividends.
Financing Activities	Includes cash raised by borrowing money or the issuance of shares and amounts repaid to shareholders and debt-holders.

Statement of Retained Earnings and Notes

Retained earnings is the amount remaining after a company's net income is distributed to shareholders in the form of dividends. The statement of retained earnings captures what is distributed to shareholders and what is retained by the company. It carries forward the previous retained earnings balance, adds the net profit from the income statement, and subtracts dividends distributed to shareholders to determine the retained earnings at the end of the period.

Companies may use retained earnings to pay off existing debt or reinvest in the company, such as pay for machinery or building a new factory.

Notes to Financial Statements

Notes to financial statements are often included to clarify financial statements or to provide additional information. Because these notes contain information that may be important for an accurate comprehension of financial statements, they should be carefully studied. Here is a partial list of what topics might appear in notes to financial statements:

- consolidation of financial statements between parent company and its subsidiaries
- deferred income taxes

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- lease obligations
- the method of converting transactions in foreign currencies to Canadian dollars
- investment holdings
- legal actions in progress against the company

Common Ratios Used in Financial Analysis

Financial ratios are used to evaluate a company's financial statements. Portfolio managers use financial ratios to compare a company's financial information to a benchmark or to other companies in the same industry. Since ratios are relative numbers, portfolio managers may directly compare two companies of very different sizes.

Ratios are calculated over several years to look for trends and opportunities. They also provide information about the direction of the security's future prices, as well as warning signals about companies in financial distress.

There are four main types of financial ratios:

- profitability
- liquidity
- debt-equity
- valuation

NOTE: Although you will not be tested on the formulas used to calculate the different ratios, you are expected to understand their significance.

Profitability and Liquidity Ratios

Profitability Ratios

Profitability ratios measure a company's ability to generate profits from its resources. The data used to calculate profitability ratios is found primarily on the income statement.

One of the profitability ratios is the gross profit margin, which shows the percentage of revenue left over after a company pays for the cost of goods sold.

Gross Profit Margin = (revenue – cost of goods sold) ÷ revenue

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Liquidity Ratios

A company's liquidity ratios tell us whether it has sufficient resources to meet current financial obligations. A commonly used liquidity ratio is the current ratio, which shows a company's ability to pay its short-term debt. The higher the ratio, the greater the company's ability to pay short-term debt.

Current Ratio = current assets ÷ current liabilities

Debt-Equity and Valuation Ratios

Debt-Equity Ratios

Debt-equity ratios gauge how heavily a company relies on borrowed money to conduct its business. Generally, a higher debt-equity ratio represents greater risk. A company with too much debt may have difficulty making interest payments, borrowing additional funds, or borrowing at a favourable interest rate. However, if used wisely, greater debt can increase productivity and profits.

Debt-Equity Ratio = (total outstanding short-term and long-term debt) ÷ shareholders' equity at book value

Valuation Ratios

Valuation ratios assess the investment value of a security in comparison to its share price. The price-to-earnings (P/E) ratio is the most well-known valuation ratio. This ratio relates the current share price to its earnings per share and shows how much investors are willing to pay for $1 of earnings. Therefore, if a company's shares are trading at a P/E of 20 that means investors are willing to pay $20 for $1 of current income. A higher P/E ratio means investors are expecting higher income in the future. This ratio allows portfolio managers to compare the earning potential of different companies.

P/E Ratio = (market price per share) ÷ (earnings per share)

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Lesson 3: Investment Fund Performance and Risk

Introduction

Investment fund performance, also called the return, is a measure of the income generated by the investment fund combined with the fund's capital appreciation over time. Investment funds, like most investments, are affected by a variety of risks. As a Dealing Representative, your clients will expect you to be knowledgeable about the return that investors can expect from different investment funds, as well as the risks associated with different fund types.

This lesson takes approximately 35 minutes to complete.

At the end of this lesson, you will be able to:

- explain how investment fund investments grow or decline in value
- explain how to calculate standard investment fund performance
- describe how investment fund distributions affect investors
- describe the effect of investment fund distributions on a fund's net asset value per unit (NAVPU)
- describe the types of investment risks that impact investment fund holdings
- explain the various measures of investment risk
- explain the relationship between risk and performance

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Sources of an Investment Fund's Return

How does an investment fund investment grow in value? Quite simply, investment funds make money in three ways:

- they earn income in the form of interest, dividends, or other income (e.g. foreign income)
- they realize capital gains (when securities are sold at a price higher than the initial purchase price)
- the price of the securities in the portfolio appreciates in value (i.e. capital appreciation)

How does an investment fund lose money? They either:

- realize capital losses (when securities are sold at a price below the initial purchase price)
- the price of the securities in the portfolio declines in value

Each individual holding in the investment fund has its own characteristics and makes a contribution to the portfolio according to those characteristics. The following illustrates how a bond or an equity holding contributes to an investment fund portfolio. For simplicity, assume the portfolio consists of only one investment.

Example

Assume you purchase a $1,000 bond at par value that pays 5% per annum. In other words, you pay $1,000 for the bond and you receive $50 in interest each year. The value of your portfolio at the beginning of the period is $1,000. We can look at several different scenarios to see how it impacts your end value at the end of one year.

Scenario	Beginning Value	Interest Income	Price (based on $100 par value)	Value of Portfolio at the end (one year later)
1	$1,000	$50	$100 – no change in price	$1,050, calculated as ($1,000 x $100 ÷ $100) + $50
2	$1,000	$50	$98 – drops in value	$1,030, calculated as ($1,000 x $98 ÷ $100) + $50
3	$1,000	$50	$101 – increases in value	$1,060, calculated as ($1,000 x $101 ÷ $100) + $50

In scenario 1, you earn $50 in interest and the price of your bond does not change. So your end value is $1,050. Basically, your portfolio is up because of the interest payment.

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In scenario 2, you earn the same interest, but your bond drops in value. Your end value is $1,030, which consists of the value of the bond based on the current market price ($980) and the interest payment ($50). Overall, your portfolio increases but your return is tempered by the drop in bond prices. If you sell the bond, you realize a capital loss of $20, calculated as $980 - $1,000. If you keep the bond, the $20 loss is an unrealized capital loss.

In scenario 3, you actually benefit from an increase in bond prices. The market value of your bond is $1,010 and along with your interest payment of $50, your end value is $1,060. So the increase is a combination of interest and price appreciation. If you sell the bond, you realize a capital gain of $10, calculated as $1,010 - $1,000. By keeping the bond, the $10 capital gain remains unrealized.

Example

Assume you purchase 100 common shares of a Canadian public company which may pay an annual dividend of $40. The price of the common shares is $10 per share so the value of your portfolio at the beginning of the period is $1,000, calculated as $10 X 100 common shares. There is no guarantee the dividend will be paid.

Let's review the impact on the end value of the portfolio based on several different scenarios.

Scenario	Beginning Value	Dividend Income	Price (based on 100 common shares)	Value of Portfolio at the end (one year later)
1	$1,000	$40	$10 – no change in price	$1,040, calculated as ($10 x 100) + $40
2	$1,000	$0	$10 – no change in price	$1,000, calculated as ($10 x $100)
3	$1,000	$40	$7 – drops in value	$740, calculated as (7 x 100) + $40
4	$1,000	$0	$7 – drops in value	$700, calculated as ($7 x 100)
5	$1,000	$40	$15 – increases in value	$1,540, calculated as ($15 x 100) + $40
6	$1,000	$0	$15 – increases in value	$1,500, calculated as ($15 x 100)

In scenarios 1 and 2, the price of the common shares does not change. With scenario 2, your end value is the same as the beginning value. You have not made or lost money. But the dividend payment in scenario 1 increases the end value by the $40 dividend.

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In scenarios 3 and 4, the price drops the value of your common shares to $700. You have an unrealized capital loss of $300, calculated as $700 - $1,000. So your portfolio is down in both these scenarios. However, the dividend payment in scenario 3 recovers some of this loss.

In scenarios 5 and 6, your portfolio is up substantially. The dividend payment pushes the end value of scenario 5 higher than scenario 6.

It is important to note that the prices of securities will fluctuate when the markets are open for trading. However, the gains or losses are not realized until the securities are sold. They are considered unrealized until that time.

Calculating Investment Fund Standard Performance

Investment fund investors are extremely interested in performance, both as a measure of their current investment values and as a yardstick in comparing potential new investments. An investment fund's performance over any time period is the result of a number of factors including:

- the performance of the financial markets in which the investment fund invests
- the investment skill of the portfolio manager
- the flow of cash in and out of the investment fund as a result of net sales and net redemptions

Standard Performance Data

The total return of an investment fund incorporates the income generated from the fund, which includes interest, dividends, realized capital gains and other income, and the capital appreciation of the investment fund over time.

There are many ways of calculating performance. Without a common methodology, comparing the performance of different funds can be very misleading. Standard performance data was developed so investors can make meaningful comparisons between funds.

For non-money market funds, standard performance data is calculated using the formula for annual compounded rate of return. The calculation assumes that any distributions from the investment fund are immediately reinvested back into the investment fund.

For money market funds, current yield and effective yield are used to show performance.
It is important to understand that a fund's past performance is no guarantee of future performance.

NOTE: You are not expected to calculate the returns for non-money market funds or money market funds. The formulas are provided to help you understand how investment fund returns are calculated.

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Non-Money Market Investment Funds Total Return

This formula allows you to calculate the standard return for non-money market investment funds, including reinvestment and compounding of distributions.

Total Return = [(redeemable value ÷ initial value) $^{(1÷n)}$ – 1] x 100

Where:

- n = the length of the performance measurement period in years, with a minimum value of 1
- initial value = the beginning net asset value of one unit or share of an investment fund
- redeemable value = the end net asset value of one unit or share of an investment fund, incorporating all distributions

Example

Leilani bought Mammoth Growth Funds three years ago. At the time, her initial value was $10. Now, she has decided to sell the investment fund.

Her redeemable value is $13. Leilani's total return is 9.13933%, calculated as [($13 ÷ $10)$^{(1÷3)}$ -1] x 100.

Money Market Investment Funds Total Return

Money market returns are calculated using two different formulas: current yield and effective yield.

Current Yield

Current yield reflects the income earned on a money market fund for the most recent seven days expressed as a simple annualized percentage.

Current Yield = [seven day return x 365 ÷ 7) x 100

Where: seven day return = income generated divided by the beginning value of the money market fund

Example

Gargantuan Money Market Fund has assets of $10,000,000. In the last seven days the fund earned $9,595 of interest. The current yield is 5.0031%, calculated as [($9,595 ÷ $10,000,000) x 365 ÷ 7] x 100.

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Effective Yield

Effective yield also calculates the return of a money market fund, but this calculation includes the effect of compounding, the concept of interest added onto the principal and then itself also earning interest.

Effective Yield = [(seven day return + 1) $^{(365\div7)}$ – 1] x 100

Example

Again looking at Gargantuan Money Market Fund, the effective yield is 5.1279%, calculated as [(($9,595 ÷ $10,000,000) + 1)$^{(365\div7)}$ - 1] x 100.

Note that due to compounding, the effective yield is higher than the current yield.

Effect of Investment Fund Distributions

In the course of a year, securities held in an investment fund will generate income; this income increases the investment fund's net asset value which in turn raises the net asset value per unit (NAVPU). When this income is eventually distributed to unitholders it lowers the net asset value of the investment fund, which results in a drop of the NAVPU.

How distributions lower NAVPU

The NAVPU is calculated by dividing the investment fund's net assets (total assets – total liabilities) by the number of units outstanding, in other words the number of units held by all the investment fund's unitholders.

NAVPU = (total assets – total liabilities) ÷ number of units outstanding

Example

The Extraordinary Dividend Fund calculates the effect of a dividend distribution on the NAVPU of their fund.

Before distribution

Before distribution, the fund's net asset value (total assets – total liabilities) is $1,000,000, and the number of units outstanding is 100,000. The beginning NAVPU is $10, calculated as $1,000,000 ÷ 100,000. Dividend income for the fund is $50,000, making the new net asset value $1,050,000, which increases the NAVPU to $10.50, calculated as $1,050,000 ÷ 100,000.

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After distribution
When the dividend income is distributed to unitholders, they receive distributions of $0.50 per unit, calculated as $50,000 ÷ 100,000. This results in the fund's total asset value dropping from $1,050,000 back to $1,000,000. The new NAVPU is $10, calculated as $1,000,000 ÷ 100,000.

How does this affect unitholders?
Candace owns 100 units of the fund. Prior to the distribution, her total fund holding is $1,050, calculated as $10.50 x 100. After the distribution, she receives a total distribution of $50, calculated as $0.50 x 100 and her investment fund is worth $1,000, calculated as $10 x 100.

Investment Fund Distribution Options

When an investment fund distributes income, unitholders can do one of two things with the distributions:

- receive a cash payment
- reinvest the distribution

If the investor chooses to receive a cash distribution, his or her number of units remains the same as before the distribution.

If on the other hand, an investor reinvests the distribution, he or she will receive additional units of the investment fund. The number of units the investor will receive is calculated as follows:

Number of new units = Income distribution ÷ NAVPU

Example

Continuing from the previous example, if Candace decides to take the cash option, she receives $50 in cash and continues to own the 100 existing units of the investment fund. However, the new value of her investment fund holdings is lower due to the reduction in NAVPU. It is $1,000, calculated as $10 x 100. Overall, the total value is $1,050, calculated as $50 cash and $1,000 investment fund holdings.

If she reinvests the $50 distribution, at the NAVPU of $10, she receives 5 additional units, calculated as $50 ÷ $10. Her total number of units after distribution increases to 105. The value of her investment fund is now $1,050, calculated as $10 x 105.

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The table below summarizes the options.

Investment	Before Distribution	After Distribution Reinvestment	After Cash Distribution
Number of Units Owned	100	105	100
NAVPU	$10.50	$10.00	$10.00
Value of Investment fund	$1,050.00	$1,050.00	$1,000.00
Cash Received	Not applicable	$0	$50.00
Total Value of Investment fund and Cash	$1,050.00	$1,050.00	$1,050.00

Investment Fund Risks

Investment fund returns like most investments are affected by a variety of risks that can be separated into three categories. We will discuss the three main categories and look at examples of those types of risks.

Systemic risk

This is the risk that a single event, such as the failure of an institution, can trigger a domino effect and harm other interconnected financial institutions. Eventually, a systemic risk can harm the whole economy. A prime example of systemic risk is the collapse of Lehman Brothers in 2008. The failure of this large investment bank reduced the stability of the entire U.S. financial system.

Systematic risk

This type of risk is also referred to as market risk because it affects everyone and cannot be avoided. Systematic risk includes events such as interest rate changes, recession, and wars. Systematic risk can be compared to the risk of bad weather. In the event of an earthquake, everyone is vulnerable.

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Systematic Risks	
Interest rate changes	Interest rate changes affect bond and stock prices. A rise in interest rates hurts existing bond investors because it lowers the price of their bonds. It also introduces reinvestment risk, in other words, the risk that interest payments will be reinvested at a lower rate. Also, an interest rate increase typically leads to a drop in security prices, as higher rates lower consumer spending and subsequently reduce business revenue.
Inflation	Inflation reduces the real return of investments, which in turn lowers the purchasing power of money.
Recession	During periods of prolonged economic slowdown, unemployment rates increase. Subsequently, consumer spending and businesses earnings fall.

Investment Fund Unsystematic Risks

This is risk specific to a given company or industry. This type of risk includes business risk and liquidity risk. For instance, poor management can lead to a decrease in a company's security prices.

Diversification can reduce the amount of unsystematic risk in a portfolio.

Unsystematic Risks	
Business Risks	The risk of a loss in the company's profits due to factors related to its business such a management quality, operational inefficiency, or competitor activities.
Liquidity Risks	The risk that you will not be able to sell your assets when you want because there are few buyers or there are restrictions preventing you from selling it. Real estate is an example of an asset with great liquidity risk. When the housing market is slow, home-sellers may not be able to find a buyer for months.
Currency Risks	A form of financial risk that occurs when investors or businesses have assets in foreign countries, and as a result require foreign currency. This risk arises from exchange rates of one currency in relation to another. If you have investments in the U.S., and the Canadian dollar appreciates relative to the U.S. dollar, the return of your U.S. investments will be reduced after the assets in the U.S. funds are converted into Canadian dollars.

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Measures of Investment Risks

The various types of risk affect the value of the securities in an investment fund. When looking at how to measure the impact of these risks, we refer to volatility. Volatility is a measure of changes of a security's value over a period of time.

Highly volatile securities experience dramatic price fluctuations in a short time period, thereby forcing a higher risk that the actual performance of an investment fund may differ from the expected performance.

Investments with lower volatility levels are those that experience a steady price change over time. As a result, these investments have a lower risk of failing to meet the expected return.

Knowing the types of risk to which securities are exposed is important in assessing the volatility level and therefore the total return of a fund.

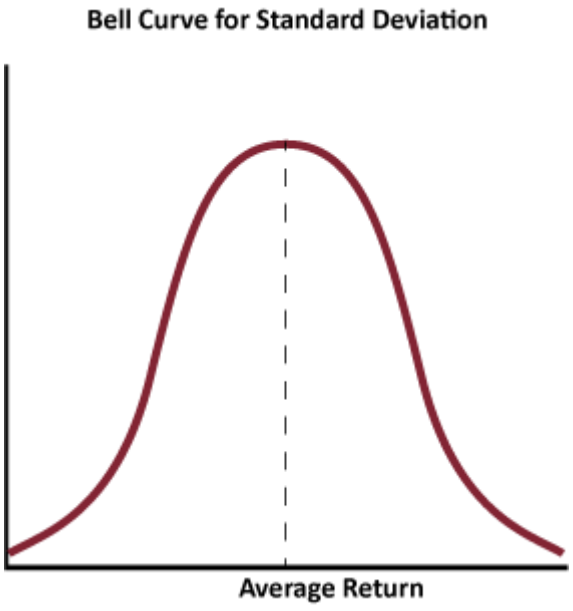
Volatility measurements include:

- standard deviation
- beta
- duration

Standard Deviation

Standard deviation indicates how much an investment fund's performance fluctuates around its average historical return over a specified period of time. Returns closer to the average historical return, indicate a lower standard deviation. This means there is a lower risk that the fund will fail to meet its average return. A higher standard deviation, on the other hand, indicates that returns are farther away from the historical average return, and denotes a higher risk that the fund will not meet its average return.

A graphical representation of this measure is the familiar bell curve. The height and width of this curve reflects the amount of variation in an investment's return.



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Example

Both the Lowell Equity Fund and the Darwin Equity Fund have an average annual return of 10%. Lowell has a standard deviation of 5 (percentage points). This means that this fund's rates of return typically fluctuate within five percentage points around its average of 10%. So, its rates of return typically range between 5% and 15%, calculated as 10% - 5% and 10% + 5% respectively.

Darwin has a standard deviation of 2. You could expect its rates of return to range from 8% to 12%, calculated as 10% - 2% and 10% + 2% respectively.

Although both funds have the same average annual returns, Lowell is a higher risk fund since it has a higher standard deviation while Darwin's lower standard deviation means its returns fluctuate within a narrower range around its average.

Beta

Beta measures the systematic risk of an investment relative to a benchmark index. With beta, investors can compare the volatility level of an investment to its peer group. As the basis of comparison, the benchmark index is assigned the value of one.

The table below summarizes the relationship between the investment's beta and volatility.

Investment Beta	Volatility Level	Investment Performance
Less than one	Lower volatility than the market	Lower risk and return than the market
Equal to one	Volatility level similar to the market	Return and risk similar to the market
Greater than one	Higher volatility than the market	Potential for higher return with higher risk than the market

Example

Ingram Diversified Fund has a beta of 1.2. Its return is expected to be 20% more volatile than the underlying benchmark index. If the benchmark returns 10%, Ingram is expected to return 12%. If the benchmark returns -10%, Ingram is expected to return -12%.

Duration

Duration is commonly used to measure the volatility of fixed income investments such as bonds. Duration refers to the number of years, calculated as the weighted average time, it will take for the bondholder to receive the present value of the interest and principal payments.

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The longer the duration, the longer bondholders will have to wait to get their interest and principal payment. As there is greater uncertainty in the future, for instance, the bond issuer can go bankrupt or interest rates may rise, longer durations mean higher risk. For instance, if two bonds have the same coupon rate, but different terms, the bond with the longer term will have a longer duration and will be more volatile.

Example

Justine is considering two bonds with the same coupon rate. Bond A matures in five years and its duration is 4.33 years while Bond B matures in ten years and its duration is 8.70 years. Bond B's duration is greater because of the longer term making it riskier than Bond A.

A bond's coupon rate will also have an effect on duration. For example, if two bonds have the same term, but different coupon rates, the bond with the lower coupon rate will have a longer duration and will be more volatile.

Example

Olaf is considering two bonds that both mature on the same day. However, Bond C offers a coupon rate of 4% and duration of 5.25 years while Bond D pays 5% interest and duration of 4.80 years. Since its coupon rate is lower, Bond C has a greater duration, and therefore is riskier than Bond D.

Since a zero-coupon bond only pays at maturity, its duration is equal to the bond's time to maturity.

Example

Daniella buys a zero-coupon bond that matures in 10 years. The duration for this bond is the same as the time to maturity, which is 10 years.

The Relationship Between Risk and Return

Investments that experience higher volatility generally have the potential for higher returns due to the dramatic changes in the price of the investment. However, price volatility includes both upward and downward price movements. Therefore, while higher volatility provides potential for larger return, it also comes with the risk of steeper losses.

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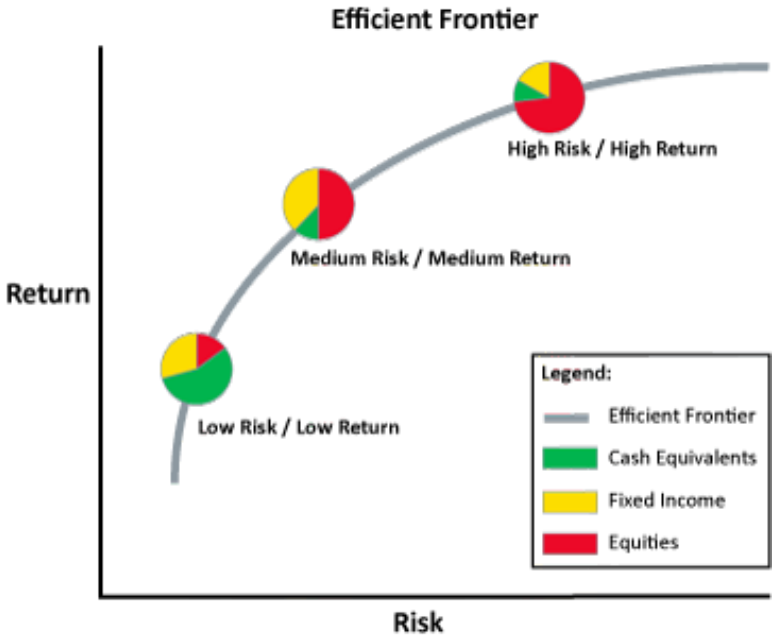
Another reason riskier investments provide higher return is that issuers offer compensation to investors as an incentive for holding higher risk investments. To compensate investors, issuers of higher risk investments typically provide a risk premium.



Investment Fund Risk Ratings

The simplified prospectus and the Fund Facts list the types of risks that affect the investment fund. The documents also classify the risk level of the investment fund.

In addition, some Fund Facts also indicate the investment fund's beta and standard deviation.

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Summary

Congratulations, you have reached the end of Unit 7: Portfolio Management.

In this unit you covered:

- Lesson 1: The Portfolio Manager
- Lesson 2: Financial Analysis
- Lesson 3: Investment Fund Performance and Risk

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 7 **Quiz** button.

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Unit 8: Mutual Funds Administration

Introduction

As a Dealing Representative, it is important that you understand how mutual funds are administered. This unit describes mutual fund administration and structure.

This unit takes approximately 3 hours to complete.

Lessons in this unit:

- Lesson 1: Mutual Fund Organizational Structure
- Lesson 2: Purchasing Mutual Funds
- Lesson 3: Redeeming Mutual Funds
- Lesson 4: Fee Structure
- Lesson 5: Disclosure
- Lesson 6: Account Types

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Lesson 1: Mutual Fund Organizational Structure

Introduction

As a Dealing Representative, you are expected to know how mutual funds are structured. In this lesson you will learn about the different ways in which mutual funds can be formed. You will also learn about the organizational structure for a mutual fund and the role of each organization within the structure.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- explain how mutual funds can be formed as trusts or corporations
- describe the roles of the different components that are involved in day-to-day operations of a mutual fund:
  - investment fund manager
  - portfolio manager
  - custodian
  - distributor
  - transfer agent
  - independent review committee

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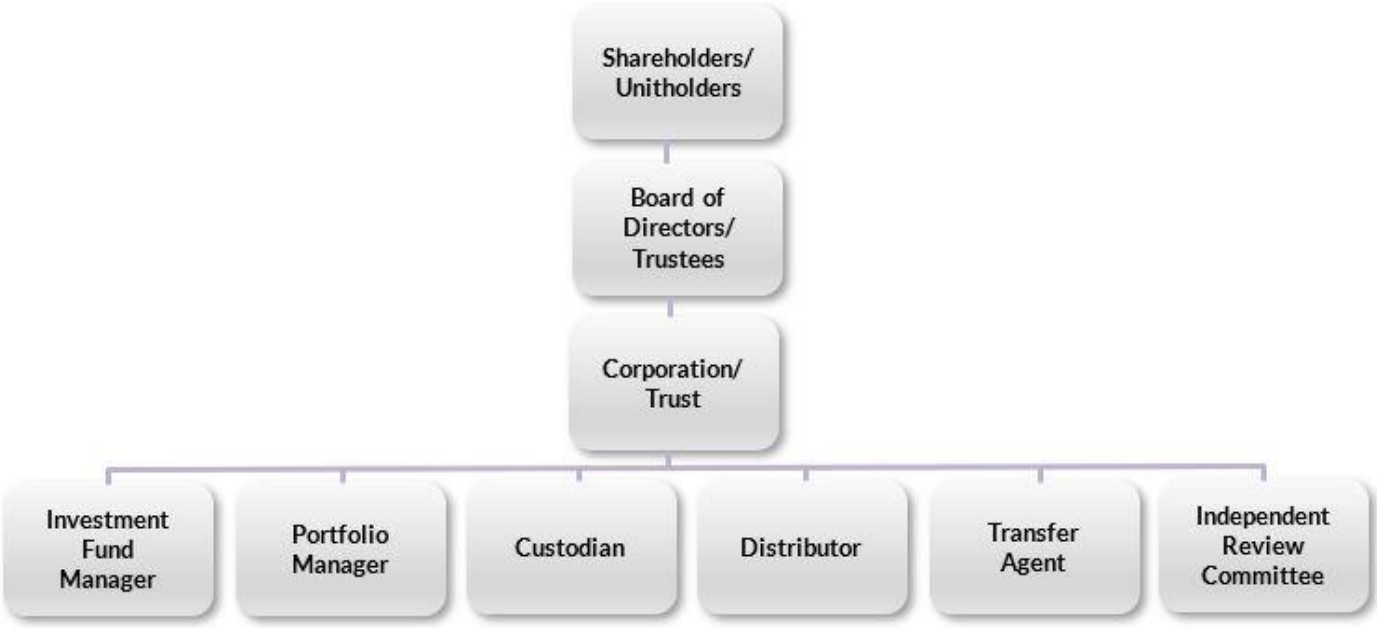
Mutual Funds as Corporations or Trusts

The mutual fund is a separate entity from the company that manages the fund. Mutual funds may be structured either as a corporation or as a trust. Investors in a mutual fund corporation are referred to as shareholders. Investors in a mutual fund trust are referred to as unitholders. Currently, most mutual funds are structured as trusts. As a result, the term unitholders will be used throughout this unit to refer to mutual fund investors. The table below summarizes the characteristics of each type of mutual fund organization.

Mutual Fund Corporation	Mutual Fund Trust
Investors are referred to as *shareholders*.	Investors are known as *unitholders* rather than shareholders.
A board of directors governs the fund.	Trusts or trustees govern the fund. There is no board of directors.
The board of directors is elected by the shareholders at the fund's annual general meeting.	Investors or unitholders typically do not have the authority to appoint the trustee(s).

Mutual Fund Organizational Structure

Behind every mutual fund is a series of organizations and individuals responsible for the day-to-day operations of the fund. Their duties range from investment strategy and selection, to the safekeeping of investor assets, to the sale and redemption of fund units.



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Role of the Investment Fund Manager

Depending on how a fund is structured, either the board of directors (in a corporation) or the trustees (in a trust) are responsible for the management of the fund's investments, as well as the day-to-day operations of the fund. Some funds hire a separate investment fund manager rather than hiring staff in-house. The investment fund manager may be a wholly owned subsidiary of a parent corporation. Banks often do this.

Typically, the investment fund manager looks at the fund's investment objectives and selects a portfolio manager with related experience. Some investment fund managers provide internal portfolio management based on similar criteria, while others use a combination of internal and external portfolio managers.

Investment fund managers are paid an annual management fee for their services. The name of the investment fund manager for a fund is disclosed in a document called the prospectus. The prospectus will be discussed in detail later in this unit.

The investment fund manager can also be referred to as the investment fund management company or mutual fund company.

Role of the Portfolio Manager

A portfolio manager is responsible for the investment decisions of a fund, including purchasing and selling securities and determining the mix of assets. In return, the portfolio manager receives management fees from the mutual funds that they oversee.

Portfolio managers are guided by the fund's investment objectives as stated in the prospectus. Portfolio managers may use specialists to help them make investment decisions. The aim of all portfolio managers is to generate the best rate of return for the fund's investors while operating within the fund's investment objectives. The name of the portfolio manager for a fund is disclosed in the prospectus.

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Role of the Custodian

The custodian is responsible for safekeeping the cash and securities belonging to the fund. The custodian is also responsible for holding the income earned by the fund until it is reinvested or distributed to fund investors. The custodian makes payments and receives monies or securities as directed by the investment fund management company.

By law, to protect investors, custodial functions of a mutual fund must be kept separate from those of the investment fund management company. This way, the management company does not have access to the securities held by the mutual fund. They are not available for any purpose other than the investment objectives of the fund. The name of the custodian for a fund is disclosed in the prospectus.

Under National Instrument 81-102, a mutual fund custodian must be one of the following:

- a Canadian chartered bank
- a Canadian trust company with shareholder equity of not less than $10 million
- a Canadian chartered bank or Trust company affiliate with shareholder equity of not less than $10 million, and incorporated under Federal or Provincial law

A custodial agreement between the fund and the custodian outlines how the custodian holds the fund assets and how the two parties interact with each other.

Custodians can appoint a sub-custodian to hold assets of the fund. This is more common for funds that have assets in other countries.

Role of the Distributor

The distributor is the sales and marketing arm of the mutual fund company responsible for bringing assets to the fund through sales to investors. The distributor sells units to investors and transmits redemption requests to the investment fund management company.

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As a Dealing Representative, you are part of the distribution network. The actual distribution can be structured in different ways:

- Dealing Representatives associated with organizations that sell their own mutual funds. These funds are referred to as “proprietary” or “in-house” products. They may also offer complementary products, such as insurance and Guaranteed Investment Certificates (GICs).

- Dealing Representatives associated with a mutual fund dealer that has distribution agreements in place with multiple mutual fund companies. The Dealing Representatives are either employees or agents of the mutual fund dealer.

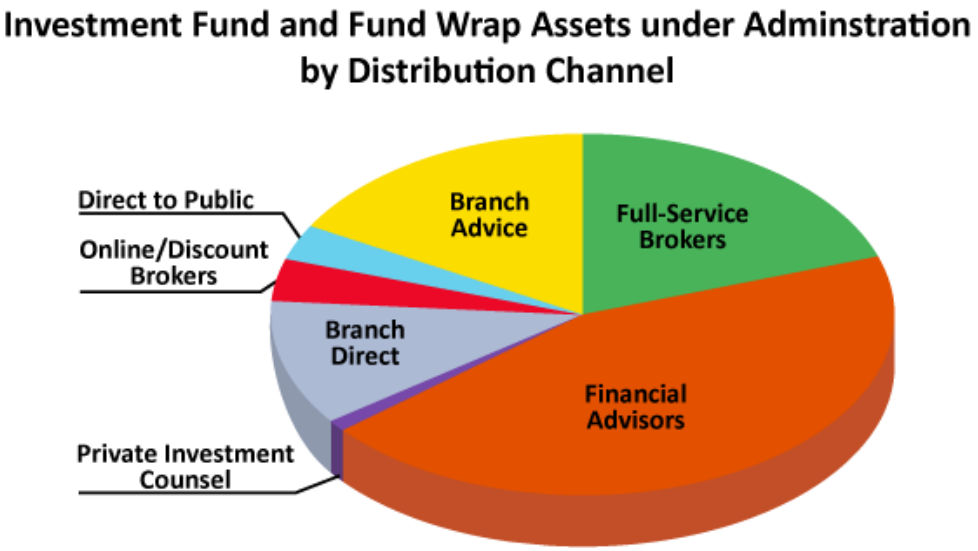
- Registered Representatives and Investment Representatives registered under investment dealers (Full-Service and Discount Brokers).

- Employees of financial institutions such as banks, trust companies, credit unions, or caisses populaires. These people are licensed to sell mutual funds, but likely perform other duties associated with their institution.

- Employees of mutual fund companies that deal directly with the public.

Market Share of Mutual Fund Assets

This graph illustrates the market share of mutual fund assets by distribution channel.



Source: Investor Economics Household Balance Sheet Report, various years

**Note: A mutual fund wrap (also called a wrap account) is typically made available by full-service brokerages. The programs allow clients to put together a personalized portfolio of mutual funds.*

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Role of the Transfer Agent

The role of the transfer agent is usually performed by a trust company. This can be the investment fund management company itself, or the custodian, or is sometimes a contracted third party. The name of the transfer agent for a fund is disclosed in the prospectus.

The transfer agent maintains the register of unitholders and records all transfers of ownership. This register changes daily as fund units are purchased and redeemed. The transfer agent may also offer a dividend distribution service.

Role of the Independent Review Committee

The securities regulation National Instrument (NI) 81-107 Independent Review Committee for Investment Funds is the harmonized regulation made by the Securities Regulators through the Canadian Securities Administrators. NI 81-107 requires all publicly offered mutual funds and investment funds to have an Independent Review Committee. The role of the Independent Review Committee is to oversee potential conflict of interest decisions involving the manager of an investment fund. NI 81-107 enhances investor protection by ensuring that an independent body focuses on the interests of the investment fund in situations where a manager of an investment fund is faced with a conflict of interest. In NI 81-107, a “manager" means a person or company that directs the business, operations and affairs of an investment fund.

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Lesson 2: Purchasing Mutual Funds

Introduction

Understanding how investors can purchase mutual funds is essential in your role as a Dealing Representative. In this lesson, you will learn how the net asset value per unit (NAVPU) is calculated, and about different approaches to purchasing mutual funds.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- explain how the net asset value per unit (NAVPU) is calculated
- differentiate between valuation and settlement date of a transaction
- describe how mutual funds can be purchased (lump sum, voluntary accumulation plans)
- describe the concept of dollar cost averaging

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Net Asset Value Per Unit

The net asset value per unit (“NAVPU” or “NAV”) is critical to a mutual fund because it represents the price at which units are bought and sold on any particular day. The NAVPU is important for investors, because it has a direct bearing on how many units their money purchases, or how much cash they receive when they redeem their fund units. Investors may also use the NAVPU to help them calculate the value of their mutual fund investment at any given time, and to monitor the performance of their securities.

The investment fund manager has the responsibility of calculating the NAVPU, usually daily. It involves assessing the value of all the fund's assets and liabilities, as well as the number of shares or units outstanding at the close of business on each valuation day.

Assets	Liabilities
• market value of fund's investment portfolio • cash • near-cash investments (those that can be quickly converted to cash) • accounts receivable (owed) from dealers	• expenses incurred for the valuation period • dividends payable to investors • redemption amounts owed to investors

Accurate market values for securities are obtained by doing the following:

- recording the closing price of a security on the financial market where most of its trading activity takes place
- setting reliable bid and ask quotations if a security is not traded, in accordance with the stated policies of the fund
- in the case of mortgages, setting a price that reflects the current rates for equivalent mortgages

All costs are accrued and expensed in accordance with International Financial Reporting Standards (IFRS). The auditor of the fund is required to confirm annually that proper valuation techniques were employed. Mutual funds, like public corporations, must be audited by an independent auditor.

Calculating the Net Asset Value Per Unit (NAVPU)

After assessing the value of all the fund's assets and liabilities, the fund manager calculates the difference between total assets and total liabilities. This result is known as the fund’s net asset value. The net asset value is then divided by the number of shares or units outstanding to determine the net asset value per unit (NAVPU). The NAVPU is calculated using the following formula:

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NAVPU = (total assets – total liabilities) ÷ number of units outstanding

Example

At the close of trading on Monday, October 4, the fund manager for the Delta Equity Mutual Fund determines that the fund held $11,000,000 worth of securities, $1,400,000 of cash and $400,000 of liabilities. The fund has 1,000,000 units outstanding. As a result, the NAVPU at the close of trading yesterday is $12, calculated as (($11,000,000 + $1,400,000) - $400,000) ÷ 1,000,000.

Valuation Date and Settlement

The valuation date of a mutual fund purchase or redemption is the date of receipt by the investment fund manager. Generally, purchases and redemptions received before 4 p.m. Eastern Time will receive that day's NAVPU. Purchases and redemptions received after 4 p.m. Eastern Time will receive the following day's NAVPU.

Some investors expect the price they receive to be based on the daily fund unit values reported in the press. You need to make your clients aware that there may be a difference between their valuation date and the one published. The calculation of the NAVPU may be delayed because of an administrative problem or valuing securities in a different time zone. There is no common practice for reporting the NAVPU for funds holding international securities.

Settlement is the date of the actual clearing of the transaction, in essence the payment of the funds and the delivery of the securities. Nowadays, settlement for most securities is almost exclusively performed on an electronic basis.

The terms of payment for transactions will be determined by the dealer. Many firms require payment at the time of purchase while other firms require payment by the settlement date. In the case of redemptions, clients will receive their proceeds by the settlement date. Settlement date will vary for different types of funds. For some funds, settlement date may be trade date plus two business days (T+2) while other funds may settle on trade date plus one business day (T+1). For most money market funds, settlement is the next business day (or sooner, if chequing privileges are available).

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Example

On Monday, October 4, Julie calls her Dealing Representative at 1:00pm Eastern Time to make a purchase in the amount of $2,400 for units in the Delta Equity Mutual Fund. The purchase price per unit is the NAVPU of that day, which we had calculated in the previous example as $12 per unit. Assuming no additional transaction costs, Julie will be able to purchase 200 units of the Delta Equity Mutual Fund, calculated as $2,400 ÷ $12. Julie must pay for the transaction on the date prescribed by the firm, which could be as early as October 4, the day Julie places her order. Since many mutual fund companies process transactions overnight on the date of purchase, funds must be available before the transaction is processed.

Methods of Purchasing Mutual Funds

One of the main advantages of mutual funds is ease of investment. Fund units can be purchased easily on any business day. Mutual funds are available through banks, investment dealers, fund companies, and a variety of other sources.

The fund prospectus and Fund Facts must describe how units can be purchased and how the fund is valued. Funds that publish the NAVPU in the press must ensure that the current NAVPU is provided on a timely basis.

There are some common methods for purchasing mutual funds: single lump-sum purchases, regular investment plans, and voluntary accumulation plans.

Single Lump-Sum Purchases

A single purchase can generally consist of any lump-sum amount, subject to the minimum purchase requirements established by individual funds. Minimum initial investments range from $500, for most funds, to $150,000 for premium funds. Lower limits often apply to purchases for RRSPs and other tax-deferral plans. Once an account has been opened, subsequent purchase requirements are generally much lower.

Regular Investment Plans

Many mutual fund sales organizations offer regular investment plans whereby an investor can make regular automatic purchases of mutual fund units. A minimum purchase is generally required and additional contributions can often be made for as little as $25. Minimum amounts vary from fund to fund.

Voluntary Accumulation Plans

With a voluntary accumulation plan, an investor agrees to invest a pre-determined amount on a regular basis (usually weekly, monthly, or quarterly). The amount of contributions can be changed at any time, and the investor can withdraw from the plan at any time.

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To encourage continued participation, these plans try to make contributing as easy as possible through pre-authorized payments from bank accounts. Acquisition charges are deducted at the time of each contribution. These plans are commonly known as a pre-authorized chequing (PAC) plans.

Dollar-cost Averaging

Investors with pre-authorized chequing (PAC) and other regular investment (RI) plans can take advantage of a risk mitigation strategy called dollar-cost averaging. With dollar-cost averaging, investors invest the same amount of money in the same mutual fund at regular intervals, such as monthly or quarterly. When unit prices are low, more units are purchased. Consequently, when unit prices are high, fewer units are purchased.

Dollar-cost averaging encourages a disciplined investing approach. After purchasers set the amount and frequency of the plan, payments can be automatically withdrawn from their bank accounts. Dollar-cost averaging also helps investors avoid the temptation of market timing. Some investors attempt the impossible task of timing the top or the bottom of the market. With dollar-cost averaging, purchases are made on a regular basis despite market conditions.

Example

Bernie would like to invest an additional $6,000 in XYZ Canadian Equity Fund, a mutual fund which he has owned units for a number of years. Tara, a Dealing Representative, recommends that Bernie open a pre-authorized chequing (PAC) plan, which will allow him to gradually purchase units of XYZ Canadian Equity Fund over a number of months. Since he is investing regularly, this strategy will help Bernie maintain a disciplined investment approach. In addition, the table below demonstrates that the average cost per unit of Bernie's purchases will actually be lower than $52.80, his cost per unit had he invested the whole $6,000 in month 1. The difference is due to fluctuations in the fund's NAVPU during the 6 month period. Of course, a different fluctuation pattern could have resulted in a higher cost per unit.

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Month	Investment Amount	NAVPU	Units Purchased
1	$1,000	$52.80	18.9394
2	$1,000	$54.83	18.2382
3	$1,000	$51.26	19.5084
4	$1,000	$50.34	19.8649
5	$1,000	$48.73	20.5212
6	$1,000	$53.80	18.5874
Totals	**$6,000**		**115.6595**

After fully investing his $6,000, Bernie will own 115.6595 units of XYZ Canadian Equity Fund. His average cost per unit is only $51.88, calculated as $6,000 ÷ 115.6595. By making purchases on a regular basis, Bernie does not need to be concerned with fluctuations in the fund's NAVPU.

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Lesson 3: Redeeming Mutual Funds

Introduction

As with the purchase of mutual funds, a thorough understanding of how mutual funds are redeemed is central to your role as a Dealing Representative. In this lesson, you will learn about the different ways in which mutual funds can be redeemed. You will also learn about how investors can switch between different mutual funds within a fund family, and also gain an understanding of the tax consequences of redeeming or switching funds.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe how mutual funds can be redeemed (lump sum, systematic withdrawal plans, series T)
- understand the tax consequences of redeeming mutual funds
- explain the concept of a mutual fund switch

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Mutual Fund Redemptions

Mutual funds provide liquidity for investors. Mutual funds can be redeemed easily and investors can receive their money quickly. On an annual basis, the fund manager must provide to investors the requirements to redeem fund units. This information is set out in the prospectus and outlines the criteria for redemption requests to be considered in "good order". Some of the items needed for a good order redemption request include:

- order received before the time stipulated in the prospectus
- order placed by the rightful owner of the units or shares to be redeemed

The fund manager must also provide information to investors on how often the fund is valued and how the redemption price is calculated.

Lump Sum Withdrawals

A single withdrawal can generally consist of any lump-sum amount, subject to the funds being available in the mutual fund. The valuation date for redemptions is the date of receipt by the investment fund manager, usually before 4 p.m. Eastern Time. Settlement date will vary for different types of funds. For some funds, settlement date may be trade date plus two business days (T+2) while other funds may settle on trade date plus one business day (T+1). For most money market funds, settlement is the next business day (or sooner, if chequing privileges are available).

Example

On Friday, July 16, Bernard places a redemption order at 6pm Eastern Time for units of his Precious Metals Fund. The valuation day for his trade will be Monday, July 19 since his order came after 4pm. Payment for the redemption will be made to the client on the settlement date.

Systematic Withdrawal Plans

Systematic withdrawal plans (SWPs) are redemption programs that allow investors to receive a regular cash flow from their holdings. These plans provide investors with three advantages:

- Withdrawals can be tailored to the client's specific cash flow needs, providing assets that are sufficient to support the payout level.
- Investments remaining in the fund continue to generate returns.
- Depending on the type of funds held, income may be eligible for preferential income tax treatment.

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A fund that offers systematic withdrawal plans must describe them in its prospectus. As well, the prospectus must specify if there is a minimum level of holdings, such as $50,000 or $100,000, before investors can take advantage of these plans.

Payment options

SWPs provide clients with flexible payment options. They can be set up to pay out at regular intervals such as monthly, quarterly, or annually. Clients can also choose to redeem:

- a ratio or percentage of holdings
- a fixed dollar amount

Ratio Withdrawal Plan

In this type of plan, the investor receives a cash flow based on a percentage of his or her portfolio's value, such as 8% or 12%. The amount paid is calculated as a fixed percentage of the average daily NAVPU during the previous payment period, or the value of the account on the last day of the previous payment period.
The withdrawal ratio is flexible, which is ideal for the investor who has immediate cash needs but whose income needs may change in the future.

If an investor's withdrawals are less than the growth of the portfolio, the investments continue to grow and the investor can withdraw more in later years without depleting the investment. However, if an investor's withdrawals exceed the fund's return or the investor excessively increases the withdrawal percentage, then the portfolio's growth is adversely affected and begins to deplete the capital.

Example

Benjamin, an investor, owns 1,000 units of a fund and sets up a ratio withdrawal plan to withdraw 10% on the 15th day of each month. The table below shows that on January 15th, the NAVPU for the fund is $20, creating a portfolio value of $20,000, calculated as 1,000 units x $20. The 10% withdrawal of $2,000 requires that 100 units of the fund be sold. With no additional distributions from the fund, the number of units owned before the next withdrawal decreases from 1,000 units to 900 units.

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Date	Units Owned	NAVPU	Portfolio Value	Withdrawal Amount	Units Sold
Jan.15	1,000	$20	$20,000	$2,000	100
Feb. 15	900	$16	$14,400	$1,440	90
Mar.15	810	$22	$17,820	$1,782	81

The withdrawal amount and number of units sold varies depending on the fund's NAVPU at redemption. In this case, Benjamin could vary the withdrawal ratio to meet his cash flow needs while also ensuring that the portfolio continues to grow.

Fixed-dollar Withdrawal Plans

With this type of plan, the investor chooses to receive a fixed amount at specified intervals, such as monthly or quarterly. Investors who have financial commitments that are relatively stable may choose this type of plan. The fund sells enough units, depending on the price, to produce the payment. Since the price may vary for each payment, it is therefore possible to experience the same risk mitigation effect for de-investing as dollar-cost averaging produces when investing. In other words, as prices fall, more units are redeemed and when prices rise, fewer units are redeemed.

Example

Using the information from our previous example, assume Benjamin owns 1,000 units of a fund and sets up a fixed-dollar withdrawal plan to receive $2,000 per month.

Date	Units Owned	NAVPU	Portfolio Value	Withdrawal Amount	Units Sold
Jan.15	1,000	$20	$20,000	$2,000	100
Feb. 15	900	$16	$14,400	$2,000	125
Mar.15	775	$22	$17,050	$2,000	90.9091

The number of units sold varies depending on the fund's price at redemption.

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Taxation on Lump Sum or Systematic Withdrawal Plans

With a systematic withdrawal plan (SWP) or lump sum withdrawal, all distributions are taxed in the year received. The prospectus must disclose the tax consequences from mutual fund dispositions. In most cases, the fund company provides tax reporting to the investor that includes:

- the average cost of units held
- the number of units redeemed during the year
- the total dollar value of payments made during the year

In addition, withholding tax will be deducted from redemptions where required under the Tax Act (for example, RRSPs). The tax rates depend on the total dollar amount of the redemption. In compliance with the Canada Revenue Agency, the appropriate withholding tax rate is applied based on the full or aggregate amount (minus fees and charges). The rate is based on the total amount of the transactions per request in an account, not on the individual transactions.

Series T

Many fund managers have launched a series of mutual funds that may be used as alternatives to SWPs. These series are usually known as Series T, where T stands for Tax. The number of the series indicates the target payout percentage. Thus, Series T6 targets an annual payout of 6%, Series T8 targets an annual payout of 8%, for example, based on the valuation of the respective fund (NAVPU) as of December 31st of the previous year. Payments typically occur monthly during the year that follows.

With Series T, it is not necessary to redeem units to provide the required cash flow. Instead, the required cash flow is provided by means of returns from investments and capital, and therefore distributions may not be fully taxable.

NOTE: Series T distributions do not always have a return of capital. For instance, if a fund is a T4 and the portfolio earns 4%, there will be no return of capital. If the distribution amount exceeds the fund's taxable income, it is characterized as a return of capital. The taxable income of an investment fund consists of Canadian dividends, foreign dividends, interest income, and net realized gains. Any distribution that does not fall into one of these categories is treated as a return of capital for tax purposes. This applies to all investment funds, not solely to Series T funds.

Example

A fund has taxable income of $0.04 per unit for the tax year and pays a distribution of $0.10 per unit. This means that $0.06 constitutes a return of capital.

Investors should consult with a qualified tax advisor for professional advice about return of capital or any other tax reporting on their investment funds.

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Sustainability of Payout

To be sustainable, the payout rate should approximate the average long-term return of the fund, taking into account its asset allocation and investment objectives. For example, a mutual fund with 80% equity normally has a higher average long-term return than a fund with 40% equity. The key word here is long-term. Over any given period, it is quite possible that either fund would outperform the other.

If distributions consistently exceed the fund's long-term return, the fund will eventually be depleted. This is the same result as with SWPs.

Over the long-term, there will be some years with positive returns and other years with negative returns. In addition to the average long-term return, the sequence of the returns also matters. For investors seeking income from their investment to supplement their retirement needs, it would be preferable for positive returns to occur early in retirement. The portfolio will usually be at its largest at the beginning of retirement and will be depleted over time as withdrawals are made. As such, it is typically preferable for positive returns to benefit the portfolio at the beginning, when it is large.

Switching Series

It is possible for an investor to change the payout rate by switching from one series to another. For example, by switching from Series T8 to Series T6, the investor reduces the annual payout rate from 8% to 6%. The switch constitutes a redemption of the Series T8 units. If held in a non-registered account, the redemption will trigger a taxable capital gain or allowable taxable loss.

However, some Series T funds have been established under the umbrella of a mutual fund corporation instead of a mutual fund trust. It is possible to switch from one class of shares to another within a mutual fund corporation without immediately triggering a taxable capital gain.

Mutual fund corporations will be examined in greater detail later in the course.

Switching Funds

Most fund companies allow you to sell units in one mutual fund to purchase units in another mutual fund among its own offerings. This transaction is called switching.

Example

Mr. Ajax is comfortable with a portfolio composed of 60% equity funds and 40% bond funds. Because equity funds have lately performed better than bond funds, equity funds now represent 70% of the market value of his portfolio and bond funds 30%.

Mr. Ajax is uncomfortable with this heavy exposure to equity funds and decides to rebalance his portfolio. He does this by switching 10% of the portfolio from the ABC Equity Fund to the ABC Bond Fund.

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A fund's prospectus outlines whether this service is available and whether a switch fee can be charged. If your client purchased a mutual fund with a deferred sales charge, there are no redemption fees charged if the client switches to another fund. In general, your client maintains the same deferred sales charge schedule as if he or she had not made the transaction.

As well, if your client had purchased the mutual fund with a front-end load, there is no sales charge applicable at the time of the switch. However, there may be an early redemption charge for redemptions or switches made within a certain time period, often the first 90 days after purchase. If your client purchased a mutual fund with an early redemption fee and decided to switch to another fund within the early redemption period, he or she would be subject to that early redemption charge. Additionally, the dealer may charge a commission of up to 2% for executing a switch transaction, regardless of whether the original units were purchased with a sales charge or a deferred sales charge.

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Lesson 4: Fee Structure

Introduction

Understanding the fee structure of mutual funds will help you to advise clients about funds which are suitable to their investment goals and time horizons. In this lesson you will learn about the management expense ratio (MER) and how it is calculated. You will also learn about fee based vs. commission-based models, no-load funds, and other fee structures.

This lesson takes approximately 35 minutes to complete.

At the end of this lesson, you will be able to:

- understand the types of costs associated with mutual funds
- explain how the management expense ratio (MER) is calculated
- explain how the MER impacts a mutual fund's performance
- describe the concept of trailer fees
- differentiate between a fee-based model and a commission based compensation model
- describe the various commission fee options
  - front-end sales charge
  - deferred sales charge
  - low-load sales charge
- explain the concept of the 10% free redemptions
- discuss the costs associated with no-load funds
- describe the fee structure for fund of funds
- describe the administrative fees associated with mutual funds or types of accounts

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Three Important Costs

There are three important costs related to mutual funds:

1. Management fees and operating expenses, paid by the fund for professional portfolio management, investment research, marketing, accounting, record keeping, and legal advice.

2. Trailer fees, fees paid by the fund to distributors.

3. Loads or commissions, paid by investors when they buy and sell mutual funds.

Mechanics of Management Fees

A management fee is the sum a mutual fund pays its investment fund manager for supervising the portfolio and administering its operations. Although the investor does not pay the management fee directly, it is paid by the mutual fund and deducted from the fund's net asset value per unit (NAVPU).

Investors should be concerned about management fees because they reduce the rate of return earned for investors in a fund. For instance, if a fund earns a 10% return over a year before management fees, and then pays out a 1.5% management fee to its management company, the return to investors will be only 8.5%. The higher the management fee, the larger the reduction and the lower the investors' return.

When the net asset value per unit (NAVPU) or rates of return are given for a fund, management fees have already been deducted. For instance, the unit values and rates of return printed in financial publications or advertisements have already taken management fees into account.

Despite this, Dealing Representatives have an obligation to advise investors that their returns will be affected by management fees. In fact, when researching investments for your clients, it is prudent to compare management fees of similar funds that share the same investment objectives.

Management Expense Ratio (MER)

To help investors compare management expenses for different funds, the Management Expense Ratio (MER) provides a standardized measure that expresses the costs of a fund as a percentage of its average net asset value during the fiscal year. To look at it another way, the MER calculates what percentage of each dollar of fund assets is being used to pay for management services.

Mutual funds are required to calculate the management expense ratio by reference to the financial statements for a financial year or an interim six-month period. The management expense ratio is obtained by dividing the total expenses of the fund before income taxes, as shown in the Statement of Operations, by the daily average net asset value for the relevant period.

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MER = (Total Annual Fund Expenses per Statement of Operations ÷ Average Net Asset Value for the Year) x 100

*For the purposes of MER calculation, total fund expenses are before income taxes and do not include commissions or portfolio transaction costs.

National Instrument 81-106 (NI 81-106) requires a fund to disclose the MERs for the last five years in its management report of fund performance.

Components of the Management Expense Ratio (MER)

The MER includes the total expenses paid by a fund to the investment fund manager and other service providers including the following:

1. management fee, including:
    a. administration of fund operations
    b. portfolio advisory services
    c. marketing and promotion
    d. financing costs

2. trailer fees

3. operating expenses, including:
    a. registrar and transfer agency fees
    b. safekeeping and custodial fees
    c. accounting, audit, and legal fees
    d. fund valuation costs
    e. costs associated with registered plans
    f. independent review committee fees and expenses
    g. costs of preparing investor communications
    h. regulatory filing fees
    i. bank and interest charges

4. interest charges and taxes (HST and sales tax)

Although commissions or brokerage fees and other portfolio transaction costs are shown as an expense in the Statement of Operations, they are excluded from the calculation of the management expense ratio. These fees are captured in the Trading Expense Ratio (TER) and can be found in documents such as the Fund Facts.

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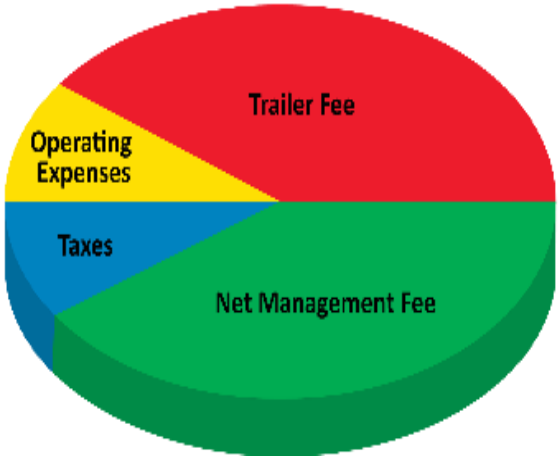
Impact of Fees and Expenses on MER

This chart displays the impact of the various fees and expenses on the overall MER.
NI 81-106 also requires disclosure of any fees or expenses absorbed or waived by the fund manager, as well as the impact of such actions on the MER. The MER calculation must also include management fee rebates to investors.



Note: The chart reflects cost components of typical mutual fund. Although trailer fees are typically embedded in the net management fee; for illustration purposes, trailer fees are shown as a separate component.

Overall cost shown of 2.4% reflects asset-weighted average MER of load paying equity funds at December 2011 (Source: Investor Economics Insight Report – Jan 2012).

How Fund Assets Affect Fees

Because fees are based on assets under management, portfolio managers have a strong incentive to increase fund assets. The more successful they are, the more they earn in fees. For instance, the manager of a fund with $100 million in net assets and a management fee of 1.5% earns $1.5 million in a year. If those assets are doubled to $200 million, the fund manager earns $3 million. This growth in assets can take place in two ways:

- capital appreciation of the existing assets, or
- an increase in the sales of fund units

A fund manager can also increase profits by controlling the costs associated with operating a fund, although these controls have less of an impact on profitability than increasing assets. When costs are lower, there are more assets available for investing against which management fees can be charged.

MERs and Performance

The MER is used to express what it costs to manage mutual funds. Funds that are actively managed, such as equity funds and asset allocation funds, tend to have MERs of 2.5% on average. Money market funds and passively managed funds designed to replicate a particular market index tend to have MERs at or below 1%. When mutual fund performance data is published, the rates of return reflect the funds' returns after the MERs have been deducted. Therefore, two funds with the same returns before expenses, but with different MERs, will have different returns after the management expenses have been deducted. The fund with the higher MER will have lower net returns.

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The management expenses are charged whether or not the fund is performing well, even if it is going down in value. To the mutual fund investor, it is the net rate of return that determines how much his or her investment will be worth, while staying invested in a fund.

Example

Rodel, age 25, is considering investing in three different equity mutual funds, Omega, Beta, and Epsilon. The three equity funds own the same securities in identical amounts. As a result, each fund is expected to earn an average annual rate of return of 9%. The only difference between the funds is in their management expense ratios; Omega, Beta, and Epsilon have MERs of 1.5%, 2.0%, and 2.5%, respectively. Rodel understands that the fund with the higher MER will have lower net returns. However, since the MERs of these funds are reasonably close together, he believes that it does not matter that much which fund he decides to invest $100,000 in. After doing some calculations, see the table below, Rodel realizes that even small differences in MER can make a big difference – especially if you hold your investments for a long period of time!

Portfolio Value of $100,000 using Different Investment Horizons and MERs (Rate of return is 9% before MERs)

Investment Horizon	Omega Equity Fund MER = 1.5%	Beta Equity Fund MER = 2.0%	Epsilon Equity Fund MER = 2.5%
10 years	$206,103	$196,715	$187,714
20 years	$424,785	$386,968	$352,365
30 years	$875,496	$761,226	$661,437
40 years	$1,804,424	$1,497,446	$1,241,607

If Rodel invests in the Epsilon Equity Fund, he will earn 30% less money than he would have if he had invested in the Omega Equity Fund.

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Limitations of the MER

It is important to be aware of the limitations of the management expense ratio. Although the MER is an extremely helpful measure of the cost of owning mutual funds, it falls short of being all-inclusive. For instance, it does not include:

- commissions paid on the purchase of units under the front-end sales charge method
- redemption fees when redeeming units purchased under the deferred sales charge method
- fees payable directly by the investor to the dealer

International Comparison of MERs

It is sometimes argued that the management expense ratios of Canadian mutual funds are among the highest in the world. The truth is that the international comparison of MERs is very difficult. The MER reflects the prevailing commercial practices, which differ from country to country. Managers and dealers are rewarded differently from one country to another. Unitholders use mutual funds for different purposes. In some countries, mutual funds are long-term investments. In other countries, they are used as substitutes for chequing accounts.

For these reasons, it is very difficult, if not impossible, to adjust for all the differences in commercial practices to allow a meaningful comparison.

Trailer Fees

As shown earlier, trailer fees represent approximately 40% of the management expense ratio, MER, for the typical load paying equity fund. The loads, or commissions, associated with a mutual fund are explained later in this unit in the discussion about commission-based models. At present, it is important to understand that trailer fees are designed as an incentive to Dealing Representatives and mutual fund dealers to continue servicing fund clients after sales have been made.

Trailer fees are paid by the investment fund management company to its distributors and are in addition to sales commissions. All, or a part, of these fees then flow to the dealer and, ultimately, to the Dealing Representative who is currently servicing the client. The dealer can receive a trailer fee for as long as the investor holds the units of the fund.

The trailer fee is paid by the manager out of the management fees and is expressed as a percentage of the dealer's assets under administration, i.e. the market value of the units of the fund sold through the dealer and not redeemed.

The size of the trailer fee depends on the option under which the units were sold. Those figures apply to equity, specialty and balanced funds. Bond funds and money market funds command lower trailer fees.
Does a fund's management expense ratio (MER) include trailer fees? Above, we listed the fees and expenses

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included in the MER. Although trailer fees were separated from management fees for illustration purposes, and are not otherwise explicitly included, the manager pays trailer fees out of management fees. As a result, trailer fees are indeed included indirectly in the MER.

Short-Term Trading and Fund of Fund Fees

Short-Term Trading Fees

Mutual funds are intended to be held as medium to long-term investments. In order to discourage short-term trading in mutual funds, a short-term trading fee is applied by fund managers. In general, short-term trading is defined as selling or switching a mutual fund within a few days, usually between 30 to 90 days, of purchase. The fee charged is between 1-3% and is paid directly to the mutual fund itself. As such, short-term trading fees benefit other investors who are holding the fund for a longer period of time. Short-term trading fees are usually not applied to money market mutual funds.

Fund of Fund Fees

A fund of funds is an investment portfolio where money is pooled and invested in a number of other funds. This type of investment can potentially increase investor diversification and access to investment opportunities. However, the fees charged will include the management fees for the underlying funds as well as a fee for managing the fund of funds. The cost of the higher management fees needs to be considered alongside the benefits of additional diversification access to investment opportunities.

Commission-Based Model

Commissions, also known as loads, are fees that are paid directly by the client. Since loads can take a number of forms, the client decides at the time of purchase how he or she wants to pay this fee. The investor has the choice of either front-end or deferred charges. The time the investor expects to hold the units will be the main factor influencing his or her decision. For a short-term purchase, the front-end option may be preferable, since the percentage charged is likely to be less. However, for a long-term investment the deferred charge may be best because potential redemption charges will gradually decline or be eliminated.

Front-end Sales Charge

The front-end sales charge is a percentage, between 0% and 9%, of the amount of the purchase, payable to the distributor from the investor's investment amount at the time of purchase. This fee is also known as a front-end load. It is usually negotiable and generally decreases as the size of the purchase increases.

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The following formula is used to calculate the purchase price of a front-end sales charge transaction:

Purchase Price per Share = NAVPU ÷ (1 - Front-end Sales Charge)

Example

Leslie invests $10,000 in a mutual fund with a 2% front-end load. The sales charge is $200, calculated as $10,000 x 2%. The current NAVPU is $10 per unit. To determine how many units she will receive, we use the above formula to determine the purchase price.

purchase price = Net asset value per unit (NAVPU) ÷ (1 - front-end sales charge)
purchase price = $10 ÷ (1 - 2%)
purchase price = $10 ÷ 0.98
purchase price = $10.20

We then divide Leslie's investment amount of $10,000 by the purchase price. She will receive 980 units, calculated as $10,000 ÷ $10.20. Do not clear your calculator for a more accurate calculation.

Deferred Sales Charge (DSC)

Funds purchased with a deferred sales charge (DSC) are bought with zero front-end sales charge, but instead are subject to redemption fees and a redemption schedule. Most redemption fees start at 6% or 7% and decline the longer the investor owns the mutual fund. Over time, the redemption fees will eventually decline to zero as established in the fund's redemption schedule. Redemption fees can be calculated based on the price of the original purchase or the market value of the units when redeemed. **DSC funds are banned in all jurisdictions effective June 1, 2022**. While new trades in DSC funds are no longer permitted, investors may hold DSC funds that were sold to them prior to the ban and redemption schedules may apply.

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Example

Bethany purchases 2,500 units of the Gamma International Equity Fund on a DSC basis. Bethany decides to sell the units in year 4 of the redemption schedule at a NAVPU of $44.46.

Redemption Fee Schedule	
Year Funds are Redeemed	**Deferred Sales Charge**
Year 1	6%
Year 2	4.5%
Year 3	3%
Year 4	1.5%
Year 5	0%

The market value of Bethany's Gamma Fund when redeemed is: 2,500 units x $44.46 = $111,150

The redemption fee for the Gamma International Equity Fund is calculated based on the market value of the units when redeemed: $111,150 x 1.5% = $1,667.25

The net proceeds of the redemption is: $111,150 - $1,667.25 = $109,482.75

Low-load Sales Charge

This low-load sales charge option is a lower cost version of the DSC option described above. The low-load redemption fee schedule is shorter in length and the value of the redemption fees start at a lower amount. **DSC funds, including low-load DSC funds, were banned in all jurisdictions on June 1, 2022**. While new trades in DSC funds are no longer permitted, investors may hold DSC funds that were sold to them prior to the ban.

10% Free Redemptions

As mentioned earlier, fund units purchased under the DSC option are subject to redemption fees for the first years in the redemption schedule. However, many fund companies allow investors to redeem up to 10% of the value of the fund each year without incurring a redemption fee, known as "10% Free". The "free" amount that may be redeemed will vary among fund companies. In some instances, investors may be able to redeem 10% of the original purchase price; in other instances, investors may be able to redeem 10% based on the market value – usually based on the value as of December 31st of the previous year. The "free" amount may be calculated based on the number of units purchased or the dollar value of the investment. The "free" amount is commonly allowed once per year and cannot be carried forward to subsequent years.

The "free" amount redeemed can be used for a number of purposes, including:

- purchasing front-end load versions of the same mutual fund
- purchasing other mutual funds offered by the fund management company
- transferring the redemption value to other investments available with other companies

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Many fund companies will automatically switch investors' "free" redemption amount into a front-end load fund version of the same mutual fund. To comply with the Mutual Fund Dealer Rules[10], these automatic switches must be done with the consent of the client and with full disclosure of any increase in trailer fees or taxes that will result.

No-load Funds

Some funds, known as no-load funds, charge no commission or service fees. A mutual fund is considered to be a no-load fund if investors are not required to pay any fee or charge to buy or redeem securities of the fund. However, some fees and charges that may be levied when an investor buys units of a no-load fund include the following:

- optional fees or charges for specific services
- redemption fees for funds that are not money market funds if redemption occurs within 90 days after purchasing the fund
- an account set-up or closing fee to cover the initial administrative costs of opening or closing the account

No-load funds are generally sold by banks and trust companies, although some independent mutual fund firms now offer no-load funds.

Fee-Based Model

As explained above, under the commission-based model the dealer is compensated by means of:

- commissions on front-end load or deferred sales charge funds
- trailer fees paid by the fund manager

Under the fee-based model, the dealer is compensated by means of an overall fee paid directly by the client. The overall fee is expressed as an annual percentage of assets under administration and covers all services provided by the dealer, whether in respect of advice or transactions. There are no additional commissions when the client purchases or redeems their mutual fund units.

[10] On January 1, 2023, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) consolidated under the Canadian Investment Regulatory Organization (CIRO). Mutual fund dealers and their Dealing Representatives are subject to the Mutual Fund Dealer Rules and Investment Dealers and their Representatives are subject to the Investment Dealer and Partially Consolidated Rules until such time that further amendments are enacted.

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Example

Mr. Jojo is a client of a mutual fund dealer and has a fee-based account. The dealer charges a flat annual fee amounting to 1% of Mr. Jojo's assets. The dealer provides advice to Mr. Jojo and purchases and redeems mutual fund units on his behalf. Mr. Jojo pays no commission to the dealer on these transactions.

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Lesson 5: Disclosure

Introduction

Before investors purchase mutual funds, dealers are required to disclose specific information about the funds. In this lesson you will learn about the disclosure requirements as well as the disclosure documents that must be provided to investors.

This lesson takes approximately 25 minutes to complete.

At the end of this lesson, you will be able to:

- describe the disclosure documents related to mutual funds:
  - Fund Facts
  - simplified prospectus
  - financial statements
  - management reports of fund performance
  - other disclosure documents

- describe the rights of investors

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Rationale for Mutual Fund Disclosure

The protection of investors is one of the primary objectives of securities legislation. Full disclosure of information material to investors' decisions is the most important means to attain this objective. Canada has a comprehensive disclosure regime for mutual funds. Funds are required to make disclosure necessary to evaluate:

- the suitability of the fund for a particular investor
- the value of the investor's interest in the fund

Disclosure Documents

The main disclosure documents prepared by a mutual fund are:

- a Fund Facts for every class or series of a mutual fund
- the simplified prospectus
- annual and interim financial statements
- annual and interim management reports of fund performance

To have a complete picture of a mutual fund, it is necessary to look at all of the listed documents. Historically, the simplified prospectus was the most important of these documents and it was delivered to every person who invested in a mutual fund. Although it incorporates the other documents by reference, the simplified prospectus is a lengthy document within which investors may have trouble finding and understanding the information they need.

In the case of mutual funds, the obligation to deliver a prospectus is replaced with an obligation to deliver the Fund Facts. The Fund Facts is an investor-friendly summary of the key features of the mutual fund, and it must be delivered to clients **before** the mutual fund is purchased. This is known as “point of sale disclosure” or “pre-sale delivery” and it provides clients with an opportunity to review important information about the mutual fund before they purchase the fund.

All the above documents are filed with the securities commissions and can be found online at The System for Electronic Document Analysis and Retrieval (SEDAR+). It is also always possible to obtain a copy without charge by contacting the fund manager.

Rights of Investors

Securities legislation in some jurisdictions gives investors the right to withdraw from an agreement to buy mutual funds within two business days of receiving the Fund Facts, or to cancel their purchase within 48 hours of receiving confirmation of their order. This investor right is called “Right of Withdrawal”.

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Securities legislation in some jurisdictions also allows investors to cancel an agreement to buy mutual funds and get their money back if they do not receive the Fund Facts, or to make a claim for damages if the Fund Facts misrepresents any fact about the fund. This investor right is called “Right of Rescission”.

The above rights must usually be exercised within certain time limits.

IMPORTANT: Rules may differ from province to province. Make sure that you are familiar with the legislation in your jurisdiction.

Fund Facts

The delivery of the most recently filed Fund Facts is a requirement under securities regulations. As mentioned earlier, the Fund Facts provides investors with important information, written in plain language, that can be used to determine the appropriateness of a mutual fund purchase.

Before you accept an order from a client or enter a trade, you are first expected to provide and explain the Fund Facts document to the client. The Fund Facts includes the information below.

Section	Information Provided
Fund Name	the name of the investment fund
Quick facts	fund code, series start date, value of fund, MER, investment fund manager (IFM), portfolio manager (PM), distributions, minimum investment required
What does the fund invest in?	top 10 holdings, a pie chart of the investment mix (depending on the fund, by asset class, business sector, or geographic region)
How risky is it?	an explanation of volatility, the fund’s risk rating (from low to high), reference to the risk section of the prospectus, a statement that the fund is not guaranteed
How has the fund performed?	a bar chart of the year-by-year returns for the past 10 years (or years available if less than 10), best and worst 3-month returns, average return (annual compounded return over the past 10 years)
Who is this fund for?	the objectives of an investor who should invest in the fund, the objectives of an investor who should not invest in the fund
A word about tax	general statement advising of potential taxes payable in registered and non-registered plans
How much does it cost?	Sales charge option (front-end or DSC), fund expenses (management expense ratio (MER), trading expense ratio (TER)), other fees (short-term trading fee, switch fee, change fee), and trailer fees

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Section	Information Provided
What if I change my mind?	Investor rights including right to withdraw from the agreement to purchase, right to cancel purchase, right to claim damages
For more information	contact information for the investment fund manager (IFM), who to contact for the fund's prospectus and other disclosure documents, link to CSA "*Understanding Mutual Funds*" brochure

Simplified Prospectus

Before a security may be offered for sale, a prospectus must be filed and approved by the provincial or territorial securities regulators of those jurisdictions where the securities are to be sold. Its purpose is to give the investor important information in a standard format to facilitate a decision whether to buy or sell units of the fund.

The prospectus is an extremely important document because it provides full disclosure of the material facts relating to a new issue of a stock, bond, mutual fund, or other type of security. Material facts are those that have, or may have in the future, a significant impact on the market value of the securities in question.

However, acceptance or clearance of the prospectus by security regulators does not guarantee that the investment is sound or provide any opinion about the merits of the investment. It only means that investors are given the material facts upon which to base an investment decision.

The simplified prospectus covers important matters such as:

- general risks of investing in mutual funds and the specific risks applicable to the fund
- fees and expenses payable by the fund
- compensation to dealers
- organization and management of the fund, including the composition of the Independent Review Committee and a summary of its mandate
- fundamental investment objectives
- investment strategies
- legal rights of investors

Depending on the jurisdiction, you must provide a simplified prospectus to a client upon request.

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Amendments to Documents

If there is a material change in a fund, such as a new commission fee structure, the *Fund Facts* and prospectus must be amended, and the amended *Fund Facts* should be provided to investors prior to the purchase of fund units.

Financial Statements

Mutual funds are required to file annual and interim (semi-annual) financial statements.
The financial statements of a mutual fund are made up of:

- a Statement of Net Assets, supported by a Statement of Portfolio Investments
- a Statement of Operations
- a Statement of Changes in Net Assets
- related notes

The annual financial statements must be audited but an audit of the interim financial statements is not mandatory.

Management Reports of Fund Performance (MRFPs)

Mutual funds must also file annual and interim management reports of fund performance (MRFPs). The MRFP contains a discussion and analysis of the fund's financial statements and discloses transactions with related parties. It also contains a wealth of statistical data, including the management expense ratio (MER) and the historical performance of the fund.

Other Disclosure Documents

In addition to the *Fund Facts*, simplified prospectus and the documents incorporated by reference, mutual funds must make certain other disclosures:

Quarterly Portfolio Disclosures

Quarterly portfolio disclosures must be prepared and posted on the fund's website within 60 days of the end of the period for which the quarterly portfolio disclosure was prepared. The disclosures should include a summary of the fund's investment portfolio at the quarter-end together with the net asset value of the fund at the same date.

Annual Proxy Voting Record

An annual proxy voting record, showing how the fund voted in respect of matters for which it received proxy materials, must be prepared and posted on the fund's website no later than August 31 of each year.

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Material Change Report

A news release must be promptly issued and filed if a material change occurs in the affairs of a mutual fund. A material change is generally a change considered important by a reasonable investor in determining whether to buy or sell the units of the fund. An example of a material change would be the replacement of a sub-adviser.

Annual Report of the Independent Review Committee

The Independent Review Committee is required to prepare an annual report for the unitholders that describes the Committee and its activities. The report must be filed with the securities commissions and posted on the fund's website.

Example

On the evening of Halloween 2006, Finance Minister Flaherty announced that he was introducing a tax on income trust distributions. The tax certainly had a material impact on income trusts and their investors. However, the introduction of the tax constituted a general change affecting all income trusts rather than a change to the business and affairs of an issuer. Consequently, the announcement did not constitute a material change for the purpose of securities legislation and there was no obligation for income trusts to issue a press release or file a material change report.

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Lesson 6: Account Types

Introduction

There are several different registered and non-registered accounts that investors can use to meet different objectives. In this lesson you will learn about the different account types, their features and requirements.

This lesson takes approximately 35 minutes to complete.

At the end of this lesson, you will be able to:

- differentiate between client and nominee accounts
- differentiate between registered and non-registered accounts
- explain the main features of registered education savings plans (RESPs)
- explain the main features of registered disability savings plans (RDSPs)
- explain the main features of tax-free savings accounts (TFSA)
- explain the main features of first home savings accounts (FHSAs)

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Client Name Accounts vs. Nominee Name Accounts

A mutual fund dealer is required to record and maintain adequate records of client information and trade instructions, whether those instructions have been executed or not. How mutual fund transactions take place among the client, the mutual fund and the mutual fund company depends on the custodial agreement. The custodial agreement refers to how property, in this case a mutual fund, is held on behalf of a client. Mutual funds are held in two types of accounts: client name accounts and nominee name accounts.

When a mutual fund transaction is administered through a client name account, the registered/legal owner of the mutual fund is the client. When a client account is established in 'nominee name', also known as 'street name', the registered/legal owner of the mutual fund is the dealer. In this case, the mutual fund dealer holds the mutual fund in trust for the actual owner, the client. A Limited Authorization Form (LAF) is not required when an account is established in nominee name.

Regardless of how mutual funds are held, a dealer must record and maintain adequate records of trade instructions. Discretionary trading, where a dealer can complete transactions without client consent, is not permitted. The table below highlights the key characteristics of each account type.

	Client Name	Nominee
Registered/legal owner of purchased mutual funds	Client	Dealer
Limited Authorization Form (LAF) required	No, but optional	No
Client instructions required	Yes	Yes
Discretionary trading permitted	No	No

Registered and Non-Registered Accounts

Registered accounts are savings plans that are defined in the federal Income Tax Act, registered with the Canada Revenue Agency (CRA), and administered by various financial institutions. These types of plans are granted special tax status wherein contributions may be tax deductible and taxes payable on any investment earnings may be deferred. There are also several limitations/restrictions on these plans including limits on the amount that may be contributed, the types of investments that may be held in the plan, the tax treatment of withdrawals, and how long the plan may remain open. The main types of registered accounts are:

- registered retirement savings plan (RRSP)
- registered retirement income fund (RRIF)
- registered education savings plan (RESP)
- registered disability savings plan (RDSP)
- tax-free savings account (TFSA)
- first home saving account (FHSA)

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Non-registered accounts have no restrictions. You can save any amount and the plan can hold almost any kind of investment. However, there are no particular tax benefits associated with non-registered accounts. Contributions are not tax deductible, and you must pay tax on the plan's investment income as you earn it. The main types of non-registered accounts are:

- cash accounts
- margin accounts

Registered Education Savings Plans

Registered education savings plans (RESPs) are attractive, tax-sheltered investment plans that allow anyone to save money for a qualified post-secondary education for anyone else, including themselves. Although anyone can open an RESP, the plan is most likely to be used to support a child's qualified post-secondary education. Usually, parents or grandparents will open an account for their child or grandchild. The child or grandchild must have a social insurance number to be a beneficiary of an RESP.

Contributors, also known as subscribers, may contribute a lifetime maximum of $50,000 per beneficiary to an RESP. The contributions that are made to an RESP are not deductible from a subscriber's income for the purpose of calculating income taxes payable. In other words, contributions are not tax deductible. There is no annual limit to the amount that can be contributed to an RESP, subject to the lifetime maximum of $50,000.

Example

George and Maria, who live in Regina, have just opened up an RESP account for their 3-year-old daughter, Alyssa. They believe she'll start university at age 18. As the contributors, George and Maria decide to contribute $2,000 per year for the next 15 years. If they have additional money available, they can contribute that amount if they stay within the $50,000 lifetime maximum. They cannot deduct their RESP contributions from their income for tax purposes but any growth on their money will be tax-sheltered while in the plan.

Canada Education Savings Grant

The Government of Canada assists families with the cost of post-secondary education by offering the Canada Education Savings Grant (CESG). The CESG is available until the end of the calendar year in which the child turns 17, as long as:

- the child is a Canadian resident
- an RESP has been opened in his or her name
- a request is made for the CESG

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The federal government will match 20% on the first $2,500 annual contribution (i.e. up to $500 CESG). If you cannot contribute or do not receive the full CESG in any given year, you may be able to catch up in future years. Qualified beneficiaries are eligible to accumulate $500 of CESG each year up to a lifetime limit of $7,200. However, the federal government will only pay a maximum of $1,000 of CESG each year per beneficiary and only up to the age of 17.

Example

Jose and Marie, who live in Vancouver, have just opened up an RESP for their newborn son, Damian. The couple contributes $1,000 into the RESP and receives a CESG payment of $200, calculated as $1,000 x 20%. Damian qualifies for $500 of CESG but only receives $200 based on the contribution. He can carry forward the $300 CESG room, calculated as $500 - $200, to a future year.

The following year, Jose and Marie contribute $4,000 into the RESP. Damian will receive a CESG payment of $800, calculated as the combination of:

- current year available grant room $500 = $2,500 x 20%
- previous year available grant room $300 = $1,500 x 20%

In addition to the CESG, residents of Saskatchewan, Alberta, and Quebec may be eligible for provincial education savings grants.

Additional Canada Education Savings Grant (A-CESG)

The federal government offers additional CESG (A-CESG) payments on contributions made by families with adjusted family net income below a certain threshold income. Adjusted net family income limits are updated every year.

The A-CESG is payable on the first $500 of annual contributions made within the year. The CESG lifetime maximum of $7200 does not change if A-CESG payments are made.

Example

George and Maria have an adjusted family net income of $25,000. As a result, their annual $1000 contribution to their 3-year-old daughter's RESP account will also generate a $100 A-CESG payment, calculated as $500 x 20%.

Canada Learning Bond (CLB)

The Canada Learning Bond (CLB) is additional money offered by the federal government for families that receive the National Child Benefit Supplement (NCBS). The maximum amount that a beneficiary may receive in their RESP account from CLB payments is $2,000, calculated as $500 payable immediately plus $100 each year

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until the child is 15 years old. To help cover the cost of opening an RESP, the CLB program will pay an extra $25 with the first $500 CLB payment. To receive CLB payments, the beneficiary must be born after December 31, 2003. CLB payments are in addition to the amount available from the CESG program.

Example

At an adjusted family net income of $25,000, George and Maria are eligible for the National Child Benefit Supplement (NCBS). As a result, they will receive an additional $525 from the Canada Learning Bond (CLB) program; $500 payable immediately plus an additional $25 to set up the RESP. In total, the couple is eligible to receive additional money from all three federal programs - the CESG, the A-CESG, and the CLB. During the year in which they open the RESP account for their daughter Alyssa, they are eligible to receive $825, calculated as:

- $200 from the CESG, calculated as $1,000 x 20%,
- $100 from the A-CESG, calculated as $500 x 20%, and
- $525 from the CLB.

In addition, they will continue to generate a $200 CESG for Alyssa on their annual RESP contribution of $1000. Also, depending on their adjusted family net income, they may be able to generate an additional $200 of A-CESG and CLB towards Alyssa's education savings.

RESP Withdrawals

Once a beneficiary is accepted into a qualified post-secondary educational institution, they become eligible to make withdrawals from their RESP. These withdrawals are called Educational Assistance Payments (EAPs). The taxable payments may consist of the CESG, A-CESG, CLB, and any investment earnings on all contributions. In addition, the contributions made by the subscriber, which are not taxable, may be paid to the beneficiary or returned to the subscriber at any time.

Withdrawals from an RESP may be used for several expenses related to the beneficiary's post-secondary education, such as tuition, books, accommodation, transportation, and computers. If the beneficiary does not immediately attend a qualified post-secondary education program, the money in the plan, except for the CLB, can be transferred to a brother or sister's RESP. The CLB is non-transferable and would have to be returned to the federal government. If transferring the plan is not an option, the contributions may be refunded to the contributor and the CESG money must be returned to the government. Any investment earnings from the RESP are paid to the subscriber as an Accumulated Income Payment (AIP) and becomes taxable income for the subscriber. It's important to note that RESPs can remain open for up to 36 years. So, you may want to wait to close the plan just in case the beneficiary decides to go to school later.

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Example

Kiran and Pavan are twins. When they were a year old, their parents opened an RESP account for each of them. 18 years later, Kiran has been accepted to a qualified post-secondary institution and Pavan has decided that any additional schooling would be a waste of time. Kiran can apply for Educational Assistance Payments from her RESP. Although EAPs are taxable, Kiran has no other income and it is unlikely that she will pay very much, if any, tax. In addition, Kiran can withdraw, at any time, the tax-free contributions her parents made to her RESP. Since Pavan is not going to school anymore, her parents have decided to transfer her RESP benefits to her twin sister. If Pavan received any CLB payments in her RESP, these would have to be returned to the federal government.

Types of RESPs

There are two basic types of RESPs:

- Individual or family self-directed RESPs
- Group or scholarship plans

Individual or family self-directed RESPs provide the subscriber with more flexibility and control over their contributions and investment options. The individual plan is ideal if you want to maintain separate RESP accounts for your children. If one child does not use their benefits, the benefits may be transferred to the other child. The individual plan also allows you to open an RESP account for children that are not related to you. You can also use this plan to open a plan for yourself or another adult.

The family plan is ideal if you have more than one child. Within a family plan, each child has their own account, but benefits may be easily shared if one or more children do not attend a qualified post-secondary institution. Under a family plan, the subscriber and beneficiary must be related, either by blood or adoption. With a group or scholarship plan, individual contributions are pooled with other participants. Usually, you must make regular contributions and the investments are determined by the scholarship plan dealer. Each group plan is different and has its own rules.

Registered Disability Savings Plan (RDSP)

A registered disability savings plan (RDSP) is a savings plan that is intended to help parents and others save for the long-term financial security of an individual who is eligible for the Disability Tax Credit. To be eligible for the Disability Tax Credit, a qualified practitioner must certify that the individual has a prolonged impairment.

Usually, contributors to an RDSP will be the beneficiary or a legal parent/guardian if the beneficiary is a minor (or an adult but not competent to enter a contract). Contributions are not tax deductible, and anyone can make contributions to an RDSP with the written permission of the plan holder. Contributors to an RDSP are not entitled to a refund of their contributions. There is no annual maximum contribution limit; however, the lifetime limit is $200,000. Contributions may be made until the end of the year when the beneficiary turns 59 years of age.

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Example

Vernon is aged 45 and disabled. He opens an RDSP. To help him in his old age, his foster mother Bernice contributes $3,000 to the RDSP. This contribution is only available to Vernon. Even if Bernice subsequently changes her mind, she cannot request a return of the contribution.

Depending on their family income, a beneficiary is eligible to receive a Canada disability savings grant and/or a Canada Disability savings bond.

RDSP Withdrawals

Payments from an RDSP must begin by the end of the year when the beneficiary turns 60. Payments from an RDSP are referred to as Disability assistance payments (DAPs). For tax purposes, the beneficiary must report any interest income, grants, and bonds paid out as part of a DAP.

Tax-free Savings Account

The tax-free savings account (TFSA) provides a way to earn investment income tax-free. Whereas other registered accounts allow the deferral of tax on income earned within the plan; the TFSA is unique in that any investment income earned within the plan is tax-free when it is withdrawn.

To open a TFSA account, you must have reached the age of majority, defined as age 18 or 19, for the province or territory in which you live. The types of investments permitted in a TFSA include:

- Cash
- Mutual funds
- Securities listed on a designated stock exchange
- Guaranteed investment certificates (GICs)
- Bonds
- Certain shares of small business corporations

TFSA Contribution Limit

The annual TFSA dollar limit was established at $5,000 in 2009, the year that TFSAs were introduced as a registered account. Depending on the rate of inflation, the annual dollar limit will be periodically increased by $500. For example, in 2013, the annual dollar limit was increased to $5,500.

If an individual over contributes to a TFSA in any month, a 1% penalty tax is payable in that month on the highest balance recorded during that month. The 1% penalty tax will be applied every month until the over contribution is withdrawn, or the excess amount is absorbed in the following year's contribution room limit. If

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an individual does not contribute to a TFSA, the contribution room is carried forward until it is used. There is no age limit as to how long you can contribute to a TFSA. Contributions to a TFSA are not tax deductible.

Example

Fernando turned 18 in 2007 and has never opened a TFSA. Now, in 2014, he has some extra savings and would like to begin contributing to a TFSA. Since he was already 18 or older when the TFSA program started in 2009, his annual TFSA dollar limit will include amounts for all the years since 2009. Based on the table below, his TFSA dollar limit for 2014 is $31,000, calculated as $5,000 + $5,000 + $5,000 + $5,000 + $5,500 + $5,500.

2009	$5,000	2017	$5,500
2010	$5,000	2018	$5,500
2011	$5,000	2019	$6,000
2012	$5,000	2020	$6,000
2013	$5,500	2021	$6,000
2014	$5,500	2022	$6,000
2015	$10,000	2023	$6,500
2016	$5,500	2024	$7,000

Withdrawals from a TFSA

The rules for withdrawing your money from a TFSA are very flexible. You can make withdrawals at any time. In addition, the amount that you withdraw, including any investment income earned, can be recontributed starting January 1st of the following calendar year. All withdrawals are tax-free. Since contributions can be carried forward and withdrawals can be re-contributed, the contribution room for a TFSA in any given year has three components:

- the maximum contribution for the current year
- any unused contribution room in the previous year
- withdrawals made from the TFSA in the previous year

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Example

Marco contributes the maximum of $6,000 to a TFSA in 2022. In August 2023, his investment has earned $1,000 of investment income. He decides to withdraw the entire amount of $7,000 to go on a vacation. He does not make any contributions in 2023.

In 2024, his contribution room is:

Maximum contribution room for 2024	$7,000
Unused contribution room in 2023	$6,500
Withdrawals made in 2023	$7,000
Contribution room for 2024	$20,500

First Home Savings Account (FHSA)

The first home savings account (FHSA) provides first-time homebuyers a way to save for a home. The FHSA offers the ability to save up to $40,000 on a tax-free basis and the annual contribution limit is $8,000. Contributions made to an FHSA are tax deductible, similar to an RRSP. In addition, the money held in the account is tax-exempt and withdrawals from the account to purchase a new home are tax-free, similar to a TFSA.

To open an FHSA, an individual must be:

- a Canadian resident
- at least 18 years old
- an individual who has not owned a home during the current year or preceding four calendar years

After an FHSA account is opened, unused FHSA contribution room can be carried forward, up to a maximum of $8,000.

There is no holding period before contributions can be used to buy a home.

Example

Padma contributes to her FHSA on March 27th. The next day, on March 28th, Padma withdraws the funds from her FHSA to purchase a new home. Since there is no holding period, Padma's contribution is still tax deductible.

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FHSA withdrawals “qualify” as tax-free where:

- the accountholder is not already a homeowner
- there is an agreement to buy or build a home in Canada by Oct. 1 of the following year

“Qualified” withdrawals can be made in a single lump sum or in a series of withdrawals.

FHSA accounts can only be open for a maximum of 15 years or until the accountholder turns 71. If an individual decides not to purchase a home with the proceeds, they can transfer the savings to their RRSP or RRIF tax-free.

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Summary

Congratulations, you have reached the end of Unit 8: Mutual Funds Administration.

In this unit you covered:

- Lesson 1: Mutual Fund Organizational Structure
- Lesson 2: Purchasing Mutual Funds
- Lesson 3: Redeeming Mutual Funds
- Lesson 4: Fee Structure
- Lesson 5: Disclosure
- Lesson 6: Account Types

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 8 **Quiz** button.

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Unit 9: Retirement

Introduction

As a Dealing Representative, your clients will expect you to know about retirement planning. In this unit, you will learn about the various types of public and private retirement savings plans. You will also become familiar with the different types and features of Registered Retirement Savings Plans (RRSPs), and the rules surrounding contribution limits.

This unit takes approximately 2 hours to complete.

Lessons in this unit:

- Lesson 1: Government and Employer Plans
- Lesson 2: Registered Retirement Savings Plans (RRSPs)
- Lesson 3: Withdrawing from RRSPs
- Lesson 4: Locked-In Accounts

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Lesson 1: Government and Employer Plans

Introduction

As a Dealing Representative, it is very important that you understand the different types of government and employer plans that are available to create a sound investment strategy for your clients.

This lesson takes approximately 45 minutes to complete.

At the end of this lesson, you will be able to:

- identify ways in which people finance their retirement

- describe the main features of the following government-sponsored programs:
  - Old Age Security (OAS)
  - Guaranteed Income Supplement (GIS)
  - Allowance
  - Allowance for the Survivor
  - Canada Pension Plan (CPP)
  - Québec Pension Plan (QPP)

- describe the main features of the following employer-sponsored programs:
  - Defined benefit pension plans (DBPPs)
  - Defined contribution pension plans (DCPPs)
  - Individual pension plans (IPPs)
  - Deferred profit sharing plans (DPSPs)
  - Non-Registered Savings Plan (NREG)

- explain the concept of the pension adjustment, past service pension adjustment, and pension adjustment reversal

- discuss the pension income splitting rules

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How Do People Finance Their Retirement?

Many Canadians share the investment goal of having a comfortable retirement. To retire at our desired age, we must develop an investment strategy that will provide enough money at retirement to support the desired retirement lifestyle. Most of us expect to retire around the age of 65 with enough post-retirement income to maintain the standard of living we have enjoyed before leaving our jobs.

Graphically, a retirement strategy can include some of the following elements for retirement income benefits:

Government-Sponsored Retirement Programs

There are two main government-sponsored programs that can help finance retirement:

- Old Age Security (OAS)
- Canada Pension Plan (CPP)/Québec Pension Plan (QPP)

Old Age Security (OAS) Program

The Old Age Security program includes four public pension benefits:

- Old Age Security (OAS) pension
- Guaranteed Income Supplement (GIS)
- Allowance

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- Allowance for the Survivor

The benefits paid by the federal government through each of these programs are funded by general tax revenues. In other words, there is no contribution requirement for individuals to qualify for OAS benefits. The only qualifying criteria are age and a residency requirement. OAS program benefits are indexed every quarter to address increases in the cost of living. OAS program benefits are not paid automatically to eligible recipients when they turn 65. Rather, the program requires that your eligible clients apply to begin receiving the OAS benefit.

All OAS program benefits are subject to a "means test". If your client's income exceeds a certain minimum, their OAS program benefits will be reduced, or "clawed back".

Old Age Security (OAS) Pension

The OAS pension is a monthly pension payment payable to eligible individuals. OAS pension benefits are considered taxable income.

To be eligible for full payment, your client must:

- be 65 or older
- be a Canadian citizen or legal resident of Canada at the time of application approval

OR

- if your client no longer lives in Canada (a non-resident), they were a Canadian citizen or legal resident of Canada on the day preceding the day of departure from Canada
- have lived in Canada for a minimum of 10 years (or 20 years for non-residents) after reaching age 18

Individuals who have lived in Canada for 40 years after the age of 18 are eligible for 100% of the OAS pension benefit. Partial OAS pension benefit is available for those individuals who have lived in Canada for fewer than 40 years after age 18. A partial OAS pension is calculated at the rate of 1/40th of the full OAS pension for each complete year of residence in Canada after age 18. The table below summarizes the eligibility criteria.

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After age 18 and:	OAS Pension Benefit
• lived in Canada for 40 years or more	Yes, eligible for full OAS pension benefit
• lived in Canada for less than 40 years, but more than 10 years (20 years for a non-resident)	Yes, eligible for partial OAS pension benefit
• lived in Canada for less than 10 years (20 years for a non-resident)	No benefit

Example

Alice, age 68, has been living outside of Canada for the last 20 years after reaching the age of 18. She is eligible for partial OAS pension benefit. Alice's earned income in the last year before she moved out of Canada was $50,000. Alice lived in Canada for 30 full years, so her partial OAS pension benefit would be calculated as:

[30 years x (1 ÷ 40)] x $718.33 (Maximum OAS amount for 2024) = $538.75

Applying for OAS

Service Canada now has a process to automatically enroll seniors who are eligible to receive the OAS pension. If your client is eligible to be automatically enrolled, Service Canada will send them a notification letter the month after they turn 64.

If your client did not receive a letter from Service Canada informing you that they were selected for automatic enrolment, they must apply for the OAS pension. In deciding when to apply for your OAS pension, consider your client's personal financial situation.

Note: As directed under Bill C-30 (Division 31 of Part 4) which received royal assent, OAS pension payable to individuals 75 and over is set to increase by 10%. It also provides for a one-time payment of $500 to pensioners who are 75 years or older, to be paid out of the Consolidated Revenue Fund.

Deferring OAS

As of July 2013, your client can defer receiving Old Age Security (OAS) pension for up to 60 months (5 years) after the date they become eligible for an OAS pension in exchange for a higher monthly amount. If your client delays receiving your OAS pension, the monthly pension payment will be increased by 0.6% for every month that they delay receiving it, up to a maximum of 36% at age 70. If your client chooses to defer receipt of OAS, they will not be eligible for Guaranteed Income Supplement (GIS) and their spouse or common law will not be eligible for the Allowance benefit for the period that OAS is delayed.

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OAS Pension Clawback

As mentioned earlier, the OAS pension benefit is subject to a "means test". For example, at 2023 rates, for every $1 of net income your client earns over $86,912, they lose $0.15. This reduction in benefits is commonly referred to as an OAS "clawback". At an income level of $148,179 regardless of age, a recipient of the OAS pension benefit will have to repay the entire amount.

The threshold amount is updated every year. The chart below provides additional information for specific income years.

Recovery Tax Period	Income Year	Minimum Income Recovery Threshold	Maximum Income Recovery Threshold (Age 65 to 74)	Maximum Income Recovery Threshold (Age 75+)
July 2022 – June 2023	2021	$79,845	$129,757	$129,757
July 2023 to June 2024	2022	$81,761	$134,626	$137,331
July 2024 to June 2025	2023	$86,912	$142,609	$148,179

Example

Roderick, age 66, has earned income of $100,000 during 2023. As a result, his income exceeds the OAS threshold income by $13,088, calculated as $100,000 - $86,912. He will have to repay $1,963.20 of his OAS pension benefit, calculated as $13,088 x $0.15.

Guaranteed Income Supplement (GIS)

The Guaranteed Income Supplement (GIS) is available to low-income pensioners. This benefit is payable only to individuals who qualify for the OAS pension benefit. GIS is a tax-free benefit and is paid on top of the OAS pension. Individuals who have no sources of income other than the OAS pension benefit will receive 100% of the GIS. If an individual your client defers his or her OAS pension benefit, the GIS benefit is also deferred for the same period. There are four criteria used to determine your client's payment amount, as well as the maximum income threshold where they are no longer eligible:

1. if your client is single, widowed or divorced;
2. if your client's spouse/common law receives full OAS;
3. if your client's spouse/common-law does not receive full OAS or allowance;
4. if your client's spouse/common- law partner receives the allowance

GIS benefits are "means tested". For the most part, GIS payments are reduced by $1 for every $2 of base income, excluding OAS pension income. However, the actual amount is determined using a set of complex tables.

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Applying for GIS

In December 2017, Service Canada implemented a process to automatically enroll seniors who are eligible to receive the GIS. If you can be automatically enrolled, Service Canada will send you a notification letter the month after you turn 64.

If you did not receive a letter from Service Canada informing you that you were selected for automatic enrolment, and you wish to start receiving your OAS pension and the GIS at age 65, you should apply for them right away.

Example

Gillian, age 68, is a single pensioner with an annual income of $32,000. She received OAS payments of $8,618.76 last year. The maximum income threshold to receive a GIS payment for 2024 is $21,768. Gillian does not qualify for GIS as her income ($23,380.04) is higher than the threshold (calculated as $32,000-$8,619.96).

Allowance

The Allowance is a benefit available to low-income individuals aged 60 to 64 who are the spouse or common-law partner of a Guaranteed Income Supplement (GIS) recipient. To qualify for the Allowance, an individual must meet all of the following conditions:

- is 60 to 64 (includes the month of your 65th birthday);
- has a spouse or common-law partner that receives an Old Age Security pension (OAS) and is eligible for the GIS;
- is a Canadian citizen or a legal resident;
- resides in Canada and has resided in Canada for at least 10 years since the age of 18; and
- the annual combined income of both the GIS recipient and their spouse or common-law partner is less than the maximum allowable annual threshold.

Other situations where individuals might qualify for the Allowance:

- if the individual meets all the above eligibility conditions, but their spouse or common-law partner does not receive the OAS pension or the GIS because they are incarcerated

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- if the individual has not resided in Canada for at least 10 years since they turned 18, but they have resided or worked in a country that has a social security agreement with Canada, they may still qualify for a partial benefit. For the list of countries with which Canada has established a social security agreement, refer to the Canada Revenue Agency for Lived or living outside Canada.

Individuals are reviewed every year to determine whether they continue to be eligible for the Allowance. The Allowance stops the month after your 65th birthday, when you may become eligible for the OAS pension and possibly the GIS.

Applying for the Allowance

Your client should apply for the Allowance 6 to 11 months before their 60th birthday. Applications must be made in writing using the appropriate Allowance for Survivor forms and including certified true copies of the required documentation.

Allowance for Survivor

The Allowance for Survivor is a benefit available to low-income seniors who meet the following criteria:

- has a spouse or common law partner that has died and the person has not remarried or entered into a common-law partnership
- is 60 to 64 (includes the month of your 65th birthday);
- is a Canadian citizen or a legal resident at the time the Allowance for survivor was approved, or the last time they lived in Canada;
- has lived in Canada for at least 10 years after reaching the age of 18.

Currently, the maximum allowance for a survivor is $1,626.20 per month, tax-free. The allowance for survivor stops being paid in the following situations:

- the individual has not filed an individual Income Tax and Benefit Return with the CRA by April 30th, or if, by the end of June each year, CRA has not received the information about the net income for the previous year;
- the individual leaves Canada for more than six consecutive months;
- the individual's net income is above the maximum annual threshold of $29,328.00.
- the individual is incarcerated in a federal penitentiary because of a sentence of two years or longer;

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- the individual has reached the age of 65 (payment stop the month after your 65th birthday when you become eligible for the Old Age Security)
- the individual remarries or lives in a common-law relationship for more than 12 months; or
- the individual dies

Example

Nermina is 60 years old, and her spouse passed away. Her spouse was receiving the maximum allowance before he passed away. Nermina does not have any income, thus the maximum allowance that Nermina could receive is $1,626.20.

Guaranteed Income Supplement (GIS), Allowance, Allowance for the Survivor Exemption Amounts

Starting in July 2020, new income exemptions for the purposes of calculating the Guaranteed Income Supplement, Allowance, and Allowance for the Survivor were introduced. The new exemptions exclude the first $5,000 (existing limit of $3,500) of a person's employment and self-employment income as well as 50% of their employment and self-employment income greater than $5,000 but not exceeding $15,000. The exemption is extended to self-employment income beginning with the July 20-21 benefit year.

Canada Pension Plan (CPP) and the Québec Pension Plan (QPP)

The Canada Pension Plan (CPP) is a federally-administered program designed to provide the following:

- retirement benefits
- survivor benefits
- disability benefits
- death benefits

The benefits paid through each of these programs are funded using individual contributions. In other words, an individual (or his or her family) is not eligible to receive CPP program benefits unless they have made contributions to the program. CPP program benefits, except for the death benefit, are indexed annually for increases in the cost of living. In order to receive CPP program benefits, eligible individuals must apply.

Benefits are not automatically paid once someone reaches the age of eligibility. Applications are accepted via two methods; online through the My Service Canada Account, or via paper forms mailed to the applicable Provincial CPP office.

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The CPP program is designed to replace about 25% of an individual's pre-retirement earnings. CPP is payable to all eligible Canadians except those who worked in Québec. Benefits received under the Canada Pension Plan are taxable.

The Québec Pension Plan (QPP), sponsored by the Québec provincial government, provides benefits similar to those offered by the Canada Pension Plan (CPP) to workers in Québec. (The CPP does not apply in Québec.) The federal government and the Québec provincial government closely coordinate the CPP and QPP. Benefits received under the Québec Pension Plan are taxable.

Who Contributes to CPP/QPP?

An individual must contribute to the CPP/QPP if they do the following:

- work in Canada
- are over 18 years of age and have pensionable employment income exceeding the year's basic exemption (YBE) of $3,500

Payments into the CPP/QPP are tax deductible for employers and a tax credit for individuals. Since 2001, self-employed individuals can deduct half of their contributions and claim a tax credit for the other half. Individuals do not make contributions if they are collecting CPP/QPP disability benefits, they are not in the workforce, or they reach age 70.

Making CPP/QPP Contributions

CPP/QPP payments are based on mandatory contributions made by workers and their employers. Self-employed individuals are required to make both the employee and the employer portions of the contribution. Contributions are calculated based on a percentage of a person's annual earnings between a minimum, known as the year's basic exemption, or YBE; and a maximum, known as the year's maximum pensionable earnings, or YMPE. Contribution rates and contribution limits are established each year.

CPP CONTRIBUTION RATES		
Year	**Employer/Employee Rate**	**Self-Employed Rate**
2021	5.45%	10.9%
2022	5.70%	11.4%
2023	5.95%	11.9%
2024	5.95%	11.9%

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Additional Maximum Pensionable Earnings

Starting in 2024, a second, higher limit allows has an employed person invest an additional portion of their earnings to the CPP. This limit, known as the "year's additional maximum pensionable earnings" (YAMPE), does not replace the first earnings ceiling. Instead, it subjects earnings to two earnings limits. This limit is referred to as the "second earnings ceiling**"**.

The range of earnings covered by the CPP starts at the **"**first earnings ceiling". The first earnings ceiling for 2024 is $68,500. For 2024, the second ceiling is based on being approximately 7% higher than the first earnings ceiling and is $73,200. For 2025, and onwards, the "second earnings ceiling" is approximately 14% higher than what the first earnings ceiling is determined to be for that respective calendar year. The contribution rate used to make contributions for the second ceiling is 4%. Like the first earnings ceiling, the second ceiling will increase each year to reflect wage growth.

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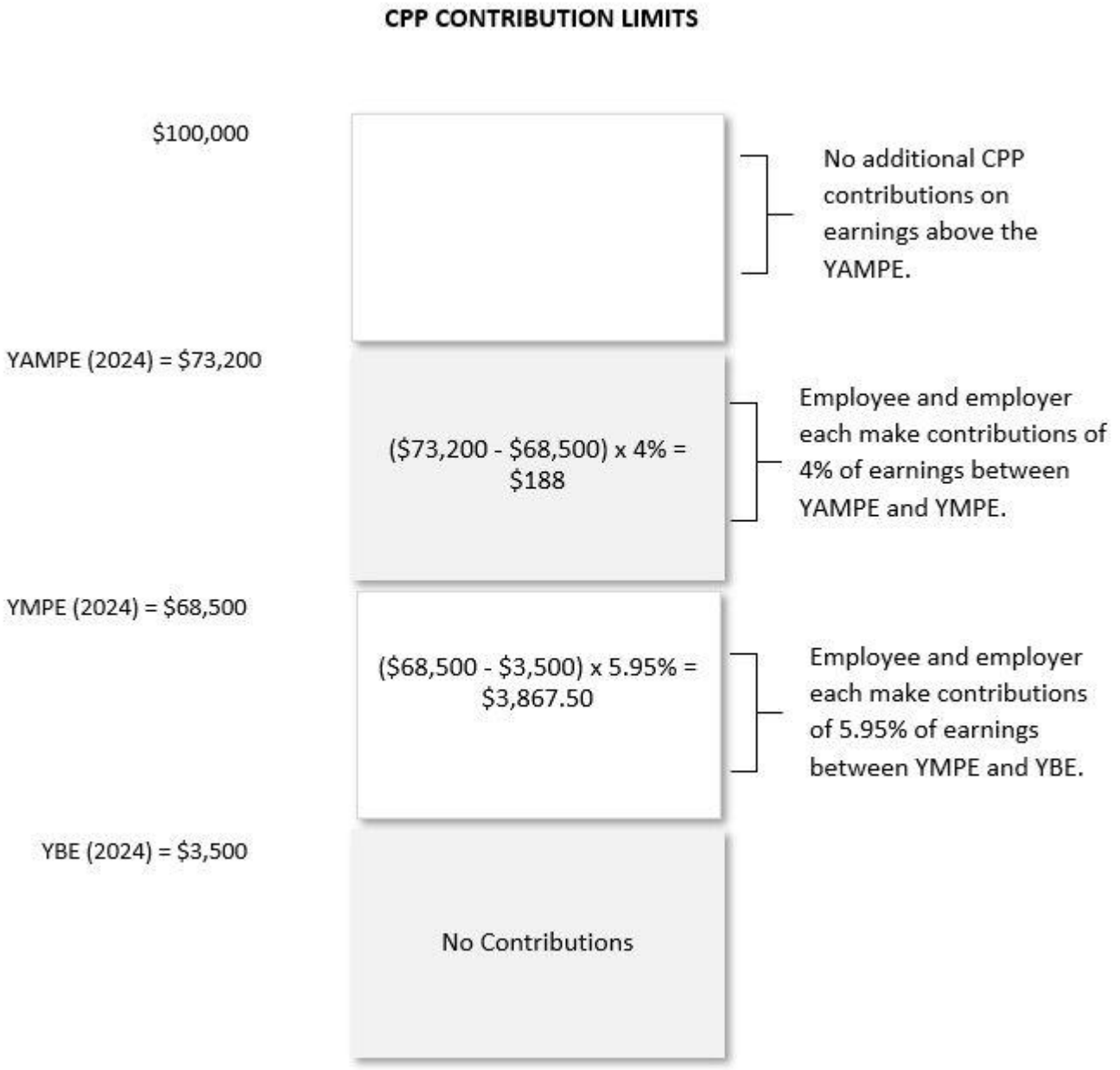
Example

In 2024, Avi had pensionable earnings of $100,000. He and his employer must each contribute 5.95% of Avi's earnings between the YMPE and YBE. In addition, Avi and his employer must each contribute 4% between the YAMPE and YMPE. As shown in the figure below, CPP contributions are made based on pensionable earnings between the YAMPE, YMPE and the YBE. Currently, the maximum employee/employer contribution is $4055.50 each, calculated as [(($68,500 - $3,500) x 5.95%) + ($73,200 - $68,500) X 4%)].


CPP CONTRIBUTION LIMITS
$100,000
No additional CPP contributions on earnings above the YAMPE.
YAMPE (2024) = $73,200
($73,200 - $68,500) x 4% = $188
Employee and employer each make contributions of 4% of earnings between YAMPE and YMPE.
YMPE (2024) = $68,500
($68,500 - $3,500) x 5.95% = $3,867.50
Employee and employer each make contributions of 5.95% of earnings between YMPE and YBE.
YBE (2024) = $3,500
No Contributions

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Early Collection of CPP/QPP Retirement Pension Benefits

As a Dealing Representative, you may need to help your clients determine when to begin collecting CPP/QPP retirement pension benefits, as part of their overall financial and retirement planning. An individual may choose to collect CPP/QPP retirement pension benefits at any time between the ages of 60 and 70. It is not necessary to stop working to receive a retirement pension. Under the CPP/QPP, normal retirement is considered to begin at age 65.

If an individual chooses to start collecting their pension prior to age 65, the CPP/QPP pension benefit is decreased. The table below provides the reduced CPP amounts.

If pension starts at:	Reduction %
60	(60 months x 0.6%) = 36%
61	(48 months x 0.6%) = 28.8%
62	(36 months x 0.6%) = 21.6%
63	(24 months x 0.6%) = 14.4%
64	(12 months x 0.6%) = 7.2%

Example

In January of 2024, Bill decided to retire early from his teaching position, a year and a half before he turns 65. Assuming he qualifies for full CPP, Bill will receive a monthly pension of $1,217.22. Calculated as $1,364.60 x 89.2%.

Late Collection of CPP/QPP Retirement Pension Benefits

If an individual chooses to start collecting CPP/QPP pension benefits after age 65, the pension benefit is increased. Currently, the amount of the retirement pension is increased by 0.7% for every month after a person's 65th birthday until age 70. This represents a maximum increase of 42%.

Example

Aurora, age 65, is eligible to receive the full CPP pension. However, she has decided to delay her pension until she is age 70. Based on current figures, Aurora will receive a monthly pension of $1,937.73, calculated as $1,364.60 x 142%.

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CPP Disability, Survivor and Death Benefits

Disability benefits are payable to eligible CPP contributors who are no longer able to work at any job on a regular basis. The disability must be long-lasting or likely to result in death. There is also a children's benefit available for the children of individuals who receive the CPP disability benefit. Survivor benefits are paid to the estate, surviving spouse or common-law partner, and dependent children of a deceased contributor. In addition to survivor benefits, a lump sum death benefit is payable to the estate of a deceased contributor. For individuals receiving the CPP Disability benefit, when they turn 65 the benefit is automatically converted to a retirement pension. They do not need to apply.

Employer-Sponsored Registered Pension Plans (RPPs)

In order to provide employees with an additional incentive to remain with the company, many employers provide benefits designed to provide employees with a pension at retirement. Registered pension plans are registered in accordance with the pension legislation of the jurisdiction, federal or provincial, in which the plan is offered. In addition, registered pension plans must meet certain registration requirements under the Income Tax Act, which is administered by the Canada Revenue Agency.

There are three basic types of registered pension plans:

- defined benefit pension plans
- defined contribution pension plans
- pooled registered pension plans

Employers generally sponsor pension plans, although in some cases unions may sponsor them. As the Pension Administrator, the plan sponsor has the responsibility for funding the plan. An employer may make all of the contributions to a registered pension plan; although employees are often required to make contributions as well.

Investment earnings on deposits within the plan grow tax-free; however, retirement benefits are taxable to the employee when they begin to withdraw money from the plan. Employee and employer contributions are tax deductible. Registered pension plan benefits are also creditor-proof, so employees cannot lose their pension benefits if they are bankrupt.

As a Dealing Representative, it is important to understand employer-sponsored pension plans. Along with government pensions, these will form the foundation of a client's retirement income. Understanding their pensions will allow you to advise on what they must do personally to supplement their retirement incomes using RRSPs, TFSAs and other investment vehicles available to them.

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Defined Benefit Pension Plans (DBPPs)

A DBPP defines the benefit that an individual will receive at retirement. The benefit is known and guaranteed and is calculated based on the type of plan. The pension plan can use the employee's average pensionable earnings to calculate the benefit. Employees' average pensionable earnings will be based on one of the following:

- their earnings throughout their career with the employer
- their earnings over their final years with the employer, usually 3 or 5 years
- their best earning years with the employer, usually 3 or 5 years

This formula is used to calculate the benefit.

Average Pensionable Earnings x Accrual Rate x Years of Service

The accrual rate is the percentage specified by the plan sponsor used to calculate the benefit entitlement. It is usually between 1% and 2% and is applied to an individual’s average pensionable earnings as determined above.

The last part of the calculation refers to the number of years of credited service.

The pension can also be based on a flat monthly amount. In this case, the plan would use the following calculation to determine an employee's benefit.

(Flat Monthly Benefit Amount x 12) x Years of Service

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Example

Babul, Oliver, and Janine are set to retire from their respective employers. The following chart highlights the information needed to determine the amount of their retirement benefit:

	Formula	Applicable Amount	Accrual Rate	Years of Service
Babul	Career Average	$85,000	1.5%	30
Oliver	Best 5 Years Average	$75,000	1.5%	30
Janine	Flat Benefit	$100 per month	N/A	30

Their retirement benefit would be calculated as:

- Babul: $85,000 x .015 x 30 = $38,250 per year
- Oliver: $75,000 x .015 x 30 = $33,750 per year
- Janine: ($100 x 12) x 30 = $36,000 per year

Defined Contribution Pension Plans (DCPPs)

A DCPP, also known as a money purchase plan, defines the contribution that an individual and their employer will make each year before the employee's retirement. The amount that the employee will receive at retirement is not guaranteed and there is no retirement formula. Since the amount that the person will have at retirement depends on how well the investments are managed, the employee is often provided with the option to choose their investments from a pre-determined list of investment options.

NOTE: The current trend among employers has been to move away from DBPPs to DCPPs, since DCPPs present less risk to corporations.

Pooled Registered Pension Plans (PRPPs)

A PRPP is a retirement savings option for individuals, including self-employed individuals. It enables its members to benefit from lower administration costs that result from participating in a large, pooled pension plan. It's also portable, so it moves with its members from job to job.

To be eligible, an individual must:

- have a valid Canadian social insurance number (SIN)
- work in a federally regulated business or industry for an employer who chooses to participate in a PRPP

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- be employed or self-employed in Yukon, Northwest Territories and Nunavut or live in a province that has the required provincial standards legislation in place.

An individual can be enrolled into a PRPP by either:

- their employer (if the employer chooses to participate in a PRPP), or
- a PRPP administrator (such as a bank or insurance company)

The investment options within a PRPP are like those for other registered pension plans. As a result, its members can benefit from greater flexibility in managing their savings and meeting their retirement objectives.

Individual Pension Plans (IPPs)

An IPP is a maximum funded defined benefit pension plan usually set up by incorporated professionals, such as dentists, or by profitable corporations for their senior executives. A maximum funded IPP is one where the accrual rate is 2%. IPPs are ideally suited for individuals who are over the age of 40 and earn more than $100,000 per year. There are several advantages to these types of plans, including:

- annual contribution limits are higher than for other registered savings plans
- contributions are tax deductible to the corporation
- contributions can be made based on past service retroactive to 1991
- retirement benefit is known and guaranteed
- additional contributions are allowed if investment performs poorly
- investment growth is not taxed until withdrawals are made from the plan
- pension benefits are creditor proof

Deferred Profit Sharing Plans (DPSPs)

A DPSP is a plan in which an employer sets aside a portion of its profits for the benefit of some or all of its employees. Only the employer may make contributions to a DPSP. The plan can be set up such that contributions are only made when the company has a profitable year. Unlike registered pension plans, the employer is not obligated to make plan contributions every year. In addition, employer contributions are tax deductible. The employee benefits from a DPSP since the plan may be set up in addition to other registered savings plans provided by the employer. As a registered savings plan, any investment growth is tax-sheltered until the employee withdraws money from the plan. Most plans have a vesting period which is an amount of time that must transpire before benefits in the retirement plan are unconditionally owned by the individual.

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Pension Adjustment (PA)

In order to maintain fairness in Canada's retirement income system, employees who belong to a registered pension plan or a DPSP are restricted in their ability to contribute to individual registered retirement savings plans (RRSPs). In Canada, approximately 40% of employees are covered by a registered pension plan; the remainder must rely on RRSP contributions to save for their retirement.

If any of your clients participate in their employer's registered pension plan or DPSP, their current RRSP contribution limits are reduced by a pension adjustment (PA). The pension adjustment reflects the amounts contributed by the client and his or her employer to a DBPP, DCPP, or a DPSP in the previous year.

Pension Adjustment (PA) Calculation

The amount of the PA depends on the type of registered plan in which the employee is participating. In general, the PA represents the amount contributed, or deemed to have been contributed, by the employee or employer. The table below highlights how the annual PA is determined for each plan type.

Plan Type	Annual Pension Adjustment (PA)
Defined Contribution Pension Plan	Amount of employer and employee contributions
Defined Benefit Pension Plan	(9 x accrual rate x pensionable earnings) - $600
Deferred Profit Sharing Plan	Amount of employer contributions

Example

Mandeep, Maeva, Jeevun, and Maansi all earn $100,000 per year. Based on this income level, they can each contribute $18,000 next year to an RRSP. However, Mandeep and her employer deposited a total of $10,000 to a DCPP, Maeva's employer deposited $5,000 to a DPSP, and Jeevun belongs to a DBPP that has an accrual rate of 1.5%. Maansi's employer does not offer a registered savings plan. As a result, their RRSP contribution room will be adjusted as follows:

Employee	Annual Pension Adjustment (PA)	RRSP Contribution Limit
Mandeep	$10,000	$8,000 ($18,000 - $10,000)
Maeva	$5,000	$13,000 ($18,000 - $5,000)
Jeevun	$12,900 (9 x 0.015 x $100,000) - $600	$5,100 ($18,000 - $12,900)
Maansi	$0	$18,000

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Past Service Pension Adjustment and Pension Adjustment Reversal

A past service pension adjustment (PSPA) occurs when the benefits of a DBPP are increased or upgraded, Similar to a pension adjustment (PA), a PSPA will decrease an individual's current RRSP contribution limit by the amount of the PSPA. Whereas a PA occurs in each year that someone is a member of a registered pension plan, a PSPA occurs much less frequently.

A pension adjustment reversal (PAR) occurs when the benefits to be received by a DBPP member are reduced or terminated. Typically, a PAR occurs when a pension plan member leaves the employer before they reach retirement age. Similarly, a PAR can occur when non-vested DPSP contributions are returned to the employer in the subsequent year(s) after when the contributions were made. The effect of a PAR is to increase the RRSP contribution limit (in other words, give the RRSP contribution room back from previous years).

Example

Paul, a member of a DPSP, ends his employment on June 12, 2024, after working for 18 months. His pension adjustment was $1,000 in 2023 and $500 in 2024. Under his employer's plan, he has to work 24 months in a row before he is vested (entitled to benefits). Paul forfeits his rights to employer contributions made to the plan on his behalf, and any earnings on the employer contributions, because he only worked for 18 months. Expressed in numbers, this means he forfeits his right to the employer's contribution of $1,500, as well as $215 of interest on this contribution. The employer's contributions were included in his PA.

PAR = $1,000 + $500

PAR = $1,500

Paul's 2024 PAR is $1,500, the amount of the employer's contributions that were included in his PA but that he did not receive because he was not vested at termination. The $215 was never included in Paul's pension credits for the PA calculation, so it is not included in his PAR. The employer still has to report the 2024 PA of $500.

Pension Income Splitting

Certain pension income, referred to as eligible pension income, may be split between a pensioner and their spouse or common-law partner. The advantage of pension income splitting is that 1/2 of the pension income that would have been taxed in the hands of the pensioner can be taxed in the hands of the spouse or common-law partner. If the spouse or common-law partner is in a lower tax bracket, the couple will save on taxes.

Some of the types of income that a pensioner can split when the pensioner is 65 years of age or older include:

- the taxable portion of life annuity payments
- a pension income from a DBPP or DCPP

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- DPSP income
- RRSP income
- RRIF income
- regular annuity payments

When a pensioner is less than 65 years of age, these amounts can only be split with a spouse or common-law partner if received directly from a pension plan or if they were received as a result of the death of a spouse or common-law partner.

Non-Registered Savings Plans

Employers may offer various types of non-registered savings plans within the group plan. Some of the types of non-registered savings plans are:

- Non-Registered Savings Plan
- Employer Profit Sharing Plan
- After-Tax Savings Vehicle
- Savings Plans

Money that is deposited into non-registered savings plans has already been taxed. As such, withdrawals will not be subject to tax, as taxes were already withheld. If there is any growth on the invested assets, the growth may be subject to investment income tax, dividends tax, and/or capital gains or losses tax.

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Lesson 2: Registered Retirement Savings Plans

Introduction

Different investors have different retirement savings requirements, depending on their current situation and future plans. This lesson defines the concept of an RRSP and explains the types of investments that qualify for RRSPs, as well as some of the benefits. You will also learn about different types of RRSPs and why they might be most appropriate for a given client. You will learn about managed RRSPs, self-directed RRSPs, group RRSPs and spousal RRSPs.

This lesson takes approximately 30 minutes to complete.

At the end of this lesson, you will be able to:

- describe the concept of an RRSP, including:
  - eligibility
  - contribution limits
  - tax deduction
  - tax deferral
  - qualified investments
  - overcontribution allowances and penalties

- describe the types of RRSPs:
  - managed (also called regular, basic, or individual)
  - group
  - self-directed
  - spousal

- explain the tax benefits of contributing to a spousal RRSP and the attribution rules

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Making RRSP Contributions

A registered retirement savings plan (RRSP) is a type of registered savings plan set up under the Income Tax Act and registered with the Canada Revenue Agency. An RRSP is not an investment; you cannot buy an RRSP. Instead, an RRSP is a registered investment vehicle within which investors can deposit various types of investments. In order to contribute to an RRSP, an individual must have earned income.

An individual may only contribute into his or her own RRSP up until December 31 of the year in which they turn 71 years of age. After that date, they may contribute to a spousal plan up until December 31 of the year in which the spouse turns age 71.

Contributions to an RRSP may take the form of cash or in-kind (non-cash) contributions. A cash contribution is made for its cash value. On the other hand, in-kind contributions are made at their current market value. If the market value exceeds the purchase price, the investment income must be reported on the investor's tax return when the asset is transferred into the RRSP.

Example

Freddie owns 500 units of the Ultima Canadian Equity Fund. Freddie purchased the units for $8,000 and they have a current fair market value of $10,000. If Freddie makes an in-kind contribution to his RRSP using these fund units, his RRSP contribution will be valued at $10,000 and he will have to report a capital gain of $2,000, calculated as $10,000 - $8,000, on his income tax return, which is taxable.

RRSP Contribution Limits

The annual RRSP contribution limit refers to the maximum amount that an individual can contribute into his or her RRSP each year. The RRSP contribution limit for the current year is based on five components, and is calculated as:

1. 18% of the investor's previous year's earned income, up to the maximum annual RRSP contribution limit

PLUS

2. Any unused RRSP contribution limit as of the end of the previous year

MINUS

3. Net changes with respect to the investor's pension adjustment (PA)

MINUS

4. Any past service pension adjustment (PSPA)

PLUS

5. Any pension adjustment reversal (PAR)

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(1) Refers to the current year's RRSP contribution limit

(2) Refers to the carry forward of unused RRSP deduction room

(3), (4), and (5) Refers to adjustments for participants in a Registered Pension Plan (RPP) or Deferred Profit Sharing Plan (DPSP)

The annual RRSP contribution limit is not a straight-forward calculation. In order to make it easier to determine the amount that an individual can contribute to his or her RRSP, the Canada Revenue Agency provides each person with a notice after they have assessed that person's tax return. Among other things, this Notice of Assessment (NOA) reports the RRSP contribution limit for the tax year following the tax year to which the NOA applies.

Annual RRSP Contribution Limit

RRSP contribution room can be calculated each year based on the lesser of:

- 18% of previous year's earned income
- the maximum annual RRSP contribution limit

Earned income generally includes net income from employment, business, and rental property, but does not include investment income (except for net rental income from property). The maximum annual RRSP contribution limit changes every year with changes in the average industrial wage, a statistic reported annually by Statistics Canada.

Example

Mario has earned income of $50,000. The current maximum annual RRSP contribution limit for the year in question is $31,560. Mario's annual RRSP contribution limit is $9,000, the lesser of:

- $9,000, calculated as ($50,000 x 18%)
- $31,560 (CRA Maximum)

Carry Forward of Unused RRSP Room

If an individual does not contribute the maximum to their RRSP, they can carry forward the remainder of the annual contribution to another year. The individual can contribute at a future date based on this carry forward amount. RRSP contribution room can be carried forward until the end of the year in which the individual reaches age 71.

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RRSP Overcontribution

In order to protect individual investors who may miscalculate their maximum contribution limit, investors are allowed to over-contribute to their RRSPs by up to $2,000. This is a lifetime maximum, not an annual allowance.

Anyone who over-contributes to an RRSP by more than $2,000 may be subject to a penalty tax of 1% of the excess for each month that they are above the $2,000 limit. In general, the penalty tax may be avoided if they take steps to withdraw the excess contributions from the RRSP account. Any RRSP withdrawals must be reported as income on an individual's tax return.

Adjustments for RPPs and DPSPs

For participants in a registered pension plan (RPP) or deferred profit sharing plan (DPSP), there may be adjustments to their RRSP contribution limit based on these plans. They will be in the form of:

- pension adjustments
- past service pension adjustments
- pension adjustment reversals

Example

Janice is a renowned scientist and university professor. Her earned income was $130,000. She is a member of the university's pension plan and has a pension adjustment of $12,000. She also has unused RRSP contribution room of $25,000. The maximum RRSP contribution limit for the year is $27,830.

To calculate Janice's RRSP contribution limit, she must first determine the amount of her annual RRSP contribution limit. It is $23,400, which is the lesser of:

- $23,400, calculated as ($130,000 x 18%); and
- $27,830

Then, she adds the $25,000 of carry forward unused RRSP contribution room.

Lastly, she deducts the pension adjustment of $12,000.

Janice can contribution a total of $36,400, calculated as ($23,400 + $25,000 - $12,000).

RRSPs & Tax Deductions

Your clients can deduct RRSP contributions from their total income. This reduces the amount of income tax they pay. The total income tax deduction that an individual may claim for a calendar year is determined by his or her RRSP contributions during the year and the first 60 days of the following year. Contributions made in

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the first 60 days of a given calendar year can be applied to the previous year rather than the year they were made.

Investors can also carry forward unused deductions, if they do not deduct RRSP contributions from their total income in the current year. This enables them to reduce their total income in future tax years, up to the end of the year in which the individual reaches age 71. If your client expects his or her income to increase significantly in the future, it may make sense to carry forward his or her income tax deductions.

Example

During 2023, Wade contributed $500 per month to his RRSP. In addition, Wade contributed a lump sum amount of $5,000 on February 15th, 2024. When Wade completes his 2023 tax return, he will be able to claim an RRSP deduction of $11,000, calculated as ($500 x 12) + $5,000. However, Wade could also carry forward a portion or all of his RRSP deduction and use it to reduce his earned income in the future.

RRSPs & Tax Deferral

The growth of money invested inside an RRSP is not subject to tax until it is withdrawn. In other words, the tax payable on investment growth is deferred until the future. Since income earned inside an RRSP is tax-sheltered, RRSP investments grow much faster than non-registered investments held outside an RRSP.

When advising your clients about tax deferral strategies, it is essential that you as a Dealing Representative consider your client's future tax obligations, as well as the tax savings, in order to ensure the best possible return for your clients in the long term.

Example

Priscilla contributes $10,000 at the beginning of each year to an RRSP account. Her brother, Miguel, contributes $10,000 at the beginning of each year to a non-registered account. Priscilla and Miguel each earn 8% compound interest on their investment. Since Miguel is investing in a non-registered account, he will pay taxes at his marginal tax rate of 40%. The table below shows how much each of them will have saved at the end of various time periods.

At the end of:	Priscilla's Registered Account	Miguel's Non-Registered Account
Year 1	$10,800	$10,480
Year 5	$63,359	$57,678
Year 10	$156,455	$130,592
Year 20	$494,229	$339,296
Year 30	$1,223,459	$672,832

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Since Priscilla's contributions and investment growth are not taxed until they are withdrawn, she will accumulate a greater amount over time. Priscilla's investment growth is fully re-invested and accumulates additional growth over and above her regular annual deposits of $10,000. An investment is said to compound when the growth of the investment itself is re-deposited to grow.

In addition, Priscilla will receive a tax deduction each year. For example, if Priscilla's income falls within a 40 percent marginal tax bracket, her $10,000 annual contribution will reduce her taxes payable by $4,000, calculated as $10,000 x 40%. If Priscilla has any remaining RRSP contribution room, she can invest this tax saving in her RRSP. Alternatively, she may invest this amount within a non-registered savings plan. As a result, Priscilla's RRSP contributions not only provide tax-sheltered growth, but also provide tax deductions that can be used to increase the benefits of investing within an RRSP.

Note that Priscilla's registered account will become taxable upon withdrawal. Given the higher dollar amount in her account as compared to Miguel, she will have a greater tax obligation when she begins withdrawing the funds.

Qualified Investments

The Income Tax Act restricts the types of investments allowed in RRSPs. Some of the investments that qualify to be held within an RRSP include:

- cash, guaranteed investment certificates (GICs), term deposits, treasury bills, and other short-term deposits
- Canada Savings Bonds, Canadian government bonds, and bonds and debentures of corporations listed on an exchange
- Canadian mortgages and mortgage-backed securities
- publicly listed stocks traded on a stock exchange
- mutual funds, exchange-traded funds
- segregated funds
- rights, warrants, and call options (if they are covered call options)
- investment-grade bullion, coins, bars, and certificates
- royalty and limited partnership units
- annuities

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Types of RRSPs

RRSP account types can be categorized as managed, group, self-directed, or spousal. The table below highlights the key differences among the four plan types. For illustration purposes assume Nisha is married to Jesse. Nisha has opened managed and self-directed accounts. She is also a member of her employer's group RRSP. Jesse has opened a spousal RRSP account.

Account Type	Managed	Group	Group Spousal	Self-Directed	Spousal
Contributor	Nisha	Nisha and/or employer	Nisha and/or employer	Nisha	Nisha
Annuitant	Nisha	Nisha	Jessie	Nisha	Jesse
Plan Sponsor	Financial Institution	Employer	Employer	Financial Institution	Financial Institution
Investment Options	Limited	Limited	Limited	All Qualified Investments	All Qualified Investments

With the exception of the Group RRSP, Nisha is the only contributor for all plan types. She is also the annuitant for all plan types except the spousal RRSPs. The plan sponsor is usually the financial institution, except in the case of group RRSP, when it is the employer. With respect to investment options, self-directed and spousal plans are the most flexible since they can hold all qualified investments in a single account.

Managed RRSPs

Managed RRSPs are the most common type of RRSPs. This type of account is opened in the name of one individual who acts as the contributor and annuitant, also known as the beneficiary. Managed RRSPs typically hold a single type of investment, such as guaranteed investment certificates (GICs), Canada Savings Bonds (CSBs), or mutual funds.

Managed RRSPs are usually held and managed by a trustee, often a trust company or bank, and are therefore called managed accounts.

Group RRSPs

Group RRSPs are a collection of managed RRSPs grouped together for administrative purposes. Group RRSPs are typically sponsored by an employer, union, or professional association. Group RRSPs are administered by a financial institution, securities dealer, or insurance company.

The table below summarizes the advantages and disadvantages of group RRSPs.

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Advantages	Disadvantages
• Since contributions are made from pre-tax payroll deductions, reducing taxable income at the source, the tax benefit is immediate. • Group RRSPs are transferable to another RRSP if you leave the employer. • Easier and less costly administration compared to a registered pension plan. • Employer contributions are optional. • Contributions and withdrawals may be made at any time unless restricted by the employer. • Group sponsored plans can offer lower fees as compared to individual plans.	• Employer chooses the plan administrator. • Potential for limited investment options. • Withdrawals by the employee during their plan participation may be restricted by the employer.

Example

Tom and Jerry both have a marginal tax rate of 40%. Beginning in January, Tom contributes $1,000 per month to his Managed RRSP through a pre-authorized chequing account (PAC) while Jerry contributes $1,000 per month to a group RRSP.

At the end of the tax year, Tom reports a $12,000 RRSP contribution, calculated as 12 x $1,000, on his income tax return. His $12,000 RRSP deduction results in a refund of $4,800, calculated as $12,000 x 40%. Jerry's monthly group RRSP pre-tax payroll deduction of $1,000 reduces his taxes immediately. Every month, Jerry saves $400 in taxes, calculated as $1,000 x 40%, he would have otherwise paid on the $1,000. At the end of the tax year, Jerry has saved $4,800 in taxes, calculated as 12 x $400.

Both Tom and Jerry save $4,800 in taxes, but Jerry receives his tax savings throughout the year while Tom must wait until after submitting his tax return to receive his tax savings.

Self-Directed RRSPs

With a self-directed RRSP, the investor selects from a wide variety of investment options. Unlike a managed account, which may only allow an investor to hold mutual funds offered by the plan sponsor/administrator; a self-directed RRSP allows an investor to mix-and-match any combination of investments, such as stocks, mutual funds, bonds, or investment-grade bullion. Investors can customize the plan to meet their needs.

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Self-directed RRSPs still require a trustee, such as a trust company, bank, investment company, or broker that sponsors and administers the plan. Typically, the trustee charges a fee for this service.

Spousal RRSPs

A spousal RRSP is a useful tool for both retirement planning and tax planning. Although the official terminology refers to a "Spousal RRSP," it's important to note that spousal RRSPs are equally applicable to common-law partners. That is, both married and common-law partners can use spousal RRSPs as a part of the overall retirement and tax planning strategies.

Terminology – Parties to a Spousal RRSP

The two parties to a spousal RRSP are:

- **Annuitant** – the annuitant is the spouse who owns the spousal RRSP account. It is therefore the annuitant who makes the investment decisions, and who eventually withdraws the money from the spousal RRSP. Typically, this is the spouse with the lower income.

- **Contributor** – the contributor is the spouse who makes contributions to the spousal RRSP account. When a contribution is made to a spousal RRSP, it is the contributing spouse who receives the corresponding income tax deduction. Typically, this is the spouse with the higher income.

Functionality – How a Spousal RRSP Works

The functionality of a spousal RRSP is best understood as a 2-step process:

1. First, one spouse (the contributor) contributes to the spousal RRSP. This spouse receives the income tax deduction, just as if they had contributed to their own RRSP.

2. Second, the other spouse (the annuitant) eventually withdraws the funds from the RRSP. It is this spouse who is then taxed on the RRSP withdrawal (subject to the attribution rule discussed below).

A spousal RRSP is essentially an income-splitting tool, and the strategy is most beneficial when the spouses or partners have significantly different incomes. Due to the nature of Canada's progressive tax rates, different levels of taxable income result in different marginal tax rates. Generally speaking, it is more tax efficient when incomes are balanced rather than one spouse having a significantly higher income than the other. Although the total household income may be the same, the total tax bill will typically be higher when there is a large discrepancy between incomes. Therefore, the desired outcome of a spousal RRSP strategy is balancing retirement income, and thereby reducing the overall household income tax payable - this is the key factor when determining whether a spousal RRSP makes sense for a client couple.

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Consider an example where a spousal RRSP is used to help a couple save for retirement, and also save taxes too.

Example

Ari and Jazmin are married. Jazmin is a corporate executive who has a significant salary and benefits plan. She earns an annual salary of $170,000 and is also a member of the company's pension plan. She is on track to have a pension that should provide the means for a comfortable retirement. Additionally, Jazmin contributes the maximum allowable amount to CPP each year, and therefore expects to receive the maximum CPP retirement benefit when she submits her application to receive it. Her husband, Ari, undertakes home renovation projects and performs other minor tasks for friends and relatives. What he generates in earned income is significantly lower than Jazmin's. As a result, Ari has very little retirement savings, and no employer-sponsored pension.

In this case, since Jazmin is generating more earned income, her total RRSP contribution room is also greater than Ari's. She uses her RRSP room to contribute to Ari's spousal RRSP instead of her own. In this structure, Jazmin is the contributor, and Ari is the annuitant of the plan. The benefits to this approach are:

- Jazmin receives a tax deduction for contributing to Ari's spousal RRSP. Due to her high level of income, the tax deduction is much greater when Jazmin contributes to Ari's spousal RRSP than if Ari had contributed to his own RRSP.
- Ari builds retirement savings. Given that he has no pension and very little savings, this will help build Ari's retirement income.
- Ari ultimately makes the withdrawals during retirement. Typically, the spousal RRSP will be converted to a spousal Registered Retirement Income Fund (spousal RRIF), and withdrawals will be taxable to Ari. As this is Ari's only known source of retirement income, it is very likely his overall retirement income and corresponding marginal tax rate will be much lower than if Jazmin's. Therefore the withdrawals are more tax-efficient in Ari's hands.

By pursuing this strategy, Jazmin and Ari can achieve a better balance between their incomes in retirement, thereby resulting in an overall tax savings.

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Spousal RRSP – Deduction and Contribution Limits

It's important to understand how RRSP limits and contribution room is affected when using a spousal RRSP. It is the contributor's RRSP contribution room that determines how much can be contributed to a spousal RRSP account. Subsequently, it is the contributor that receives the corresponding tax deduction, and that is why the contributor's RRSP contribution room is reduced accordingly. The RRSP contribution limit of the annuitant who owns the spousal RRSP is irrelevant. The annuitant of the spousal RRSP is not permitted to make contributions to the plan.

Example

Jon and Craig decide that a spousal RRSP, where Jon is the contributor and Craig is the annuitant, would be in their best interests. Currently, they contribute a total of $17,800 each year to RRSPs, calculated as $13,800 + $4,000. In order to split their contributions, they will each need to become the annuitant of $8,900, calculated as $17,800 ÷ 2. Craig will continue to contribute $4,000 to a managed RRSP. Jon will contribute $4,900 to a spousal RRSP and $8,900 to a managed RRSP. The table below displays Jon and Craig's managed and spousal RRSP savings assuming they earn a rate of return of 8% compounded annually.

	After 10 Years	After 20 years	After 30 Years
Jon's Managed RRSP	$128,930	$407,281	$1,008,221
Craig's Managed RRSP	$57,946	$183,048	$453,133
Craig's Spousal RRSP	$70,984	$224,233	$555,088
Craig's Total	$128,930	$407,281	$1,008,221
Difference in savings	$0	$0	$0

Spousal RRSP – Attribution Rule

In order to prevent abuse, the Canada Revenue Agency (CRA) has special attribution rules regarding withdrawals from spousal RRSPs. In general, when an individual makes a withdrawal from a spousal RRSP, that income is attributed back to the contributing spouse if deposits have been made to the plan in the current year or in the previous two years. For this reason, the spousal RRSP attribution rule is sometimes called the "three-year rule" or the "current plus two-year rule."

This spousal RRSP attribution rule is in place to discourage and prevent short-term transactions intended to gain an unfair tax advantage. As such, when the attribution rule is applied and the withdrawal is attributed back to the contributing spouse, the income splitting opportunity has been lost. However, after three calendar years have passed from when the most recent contribution was made, the attribution rule is no longer applicable. Any withdrawals from that point forward will then be taxed in the annuitant's hands, thereby achieving an income split between the spouses.

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Example

Harvey contributed the following amounts to his wife Patti's spousal RRSP:

Year	Harvey's Spousal RRSP Contribution
2023	$5,000
2022	$5,000
2021	$6,000
2020	$4,000

In 2024, Patti decides to withdraw $14,000 from her spousal RRSP. Who pays the taxes?
Based on the RRSP attribution rule, Harvey would pay tax on $10,000, calculated as $5,000 from his 2023 contribution and $5,000 from his 2022 contribution. Patti would pay tax on the remaining $4,000, calculated as ($14,000 - $10,000).

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Lesson 3: Withdrawing from RRSPs

Introduction

Although most of your clients will be saving for retirement, it is important to understand the alternatives available to help them make the right choice when taking money out of their retirement plans. In this lesson you will learn about the options available for withdrawing funds from an RRSP, and the tax implications for each one.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- explain the rules for terminating an RRSP

- explain the options that are available to withdraw from an RRSP and the tax consequences:
  - lump sum
  - Home Buyers' Plan (HBP)
  - Lifelong Learning Plan (LLP)

- explain the maturity options that are available for RRSP:
  - lump sum
  - annuity (life or term)
  - registered retirement income fund (RRIF)

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Terminating an RRSP

A registered retirement savings plan (RRSP) can be terminated at any time, provided it is not a locked-in plan. However, the primary purpose of an RRSP is to provide individuals with a tax-deferred retirement savings option using before-tax dollars. Although your client would benefit from allowing their RRSP deposits to earn interest that compounds over many years, they do have the flexibility to withdraw money early and/or wait until the RRSP matures.

Your client may decide to withdraw money from their RRSPs before they mature, for any reason. Although a lump sum withdrawal is an option, the federal government has created two programs that allow investors to use RRSP savings to buy a home or to pay for training or education.

On the other hand, individuals who decide to maintain some or all of their RRSP deposits must terminate or convert their RRSPs by December 31st of the year in which they turn age 71.

Example

Victor was born on January 31, 1991. From an early age, his parents have taught him that saving money for his future is an important goal. Since he began working at age 14, Victor has made regular deposits to an RRSP account at a local bank. Victor expects that he will always use his RRSP account to save for his future retirement. He will be able to maintain and deposit money into his RRSP account until the end of the year in which he turns age 71. Since Victor turns 71 in 2062, he will be able to make deposits until December 31st, 2062. By that date, he must convert his RRSP to a RRIF.

Lump Sum RRSP Withdrawals

All money withdrawn from an RRSP is subject to income tax. The Canada Revenue Agency requires that the financial institution that sponsors the RRSP apply a withholding tax before any funds are deposited into a person's bank account. As per the table below, the amount of the tax depends on the amount withdrawn and the province of residence.

Withdrawal Amount	All of Canada (except Québec)	Québec*
From $0 to $5,000	10%	20%
From $5,001 to $15,000	20%	25%
Greater than $15,000	30%	30%

* For Québec residents the withholding tax is equal to Québec withholding tax of 15% for all withdrawal amounts plus federal withholding tax of 5%, 10% and 15% for the brackets indicated above.

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Example

Yasmine lives in Ontario. Her finished basement was badly damaged in a flood. She did not have homeowner's insurance and the basement repair bill is estimated at $12,000. Yasmine has no savings other than her RRSP. In order to fix her basement, she decides that she has no choice but to withdraw money from her RRSP. However, in order to get the $12,000 she needs now, she must withdraw enough to also cover the withholding tax. Yasmine must withdraw $15,000, calculated as $12,000 ÷ (1 – withdrawal rate of 20%).

The gross amount that Yasmine withdrew from her RRSP is then added to her annual taxable income, and the 20% tax deducted ($3,000) will be added to the tax she has paid. If the $15,000 pushes Yasmine into a higher tax bracket, and her marginal tax rate becomes higher than 20%, she may owe more taxes during income tax time.

Home Buyers' Plan (HBP) Withdrawals

The Home Buyer's Plan (HBP) allows individuals to make tax-free withdrawals from their RRSPs in order to purchase a principal residence. An individual can withdraw up to $35,000 from their RRSP under the HBP for any qualified withdrawal made after March 19th, 2019.[11] Prior to this date, maximum withdrawals were $25,000. Before participating in the HBP, the individual must have entered into a written agreement to buy or build a qualifying home. They must complete the transaction by October 1st of the year after the withdrawal. If they buy the qualifying home together with their spouse or common-law partner, or other individuals, each eligible person can withdraw up to $35,000.

To qualify as a first-time homebuyer, the individual must not have owned and lived in a home as their principal residence in any of the four calendar years prior to the year of withdrawal. Furthermore, the individual must not have occupied a home that their current spouse or common-law partner owns.

In order to maintain the tax-free status of the withdrawals, the money withdrawn must be repaid into the individual's RRSP account. The repayment period begins in the second year after the year of withdrawal.[12] Repayments made within 60 days after the calendar year end qualify as repayment for the previous year. 15 years of minimum annual payments is permitted to complete the full repayment of the HBP withdrawal.

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[11] The 2024 Federal Budget proposes to increase the withdrawal limit for the Home Buyer's Plan (HBP) to $60,000 from $35,000. Pending Royal Assent, the proposed effective date is the first day after budget day April 16, 2024 (April 17, 2024). For more information, refer to this link: https://budget.canada.ca/2024/report-rapport/toc-tdm-en.html. **This material is provided for information purposes only. For exam purposes, the course content will apply.**

[12] The 2024 Federal Budget proposes a temporary increase of three (3) years to the current two-year grace period for starting to repay money into a registered retirement savings plan (RRSP). For participants who make a first withdrawal between January 1, 2022, and December 31, 2025, the 15-year repayment period would start in the fifth (5th) year after the year of the first withdrawal. Pending Royal Assent, the proposed effective date is the first day after budget day April 16, 2024 (April 17, 2024). For more information, refer to this link: https://budget.canada.ca/2024/report-rapport/toc-tdm-en.html. **This material is provided for information purposes only. For exam purposes, the course content will apply.**

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The minimum annual payment for a HBP repayment is based on the HBP withdrawal balance divided by the number of years remaining to complete the full repayment of the withdrawal. However, if more than the annual minimum payment is paid for a respective calendar year, then for subsequent years, the annual minimum payment will be reduced. Any missed or incomplete payments are considered income by the Canada Revenue Agency (CRA) and subject to tax. The HBP withdrawal balance still declines even if there are missed or incomplete payments. The HBP is not available for RRIFs, or any locked-in accounts such as LIRAs, LIFs, RLIFs, LRIFs, or PRIFs.

Example

Adam and Joanna were married in 2023 and are looking forward to purchasing a new home together. Since Adam had owned a home as a principal residence the year prior to getting married, he is not eligible for the HBP program. However, Joanna has never owned a home and did not live with Adam in his home during the period he owned it. She is, therefore, able to withdraw the full $35,000 from her RRSP. If Joanna withdrew funds some time during 2023, they must acquire a home by October 1, 2024. Joanna can make her first annual repayment for the 2025 calendar year any time before March 1, 2026. The amount of her repayment will be 1/15 of $35,000, or $2,333.33.

Lifelong Learning Plan (LLP) Withdrawals

The Lifelong Learning Plan (LLP) allows individuals to make tax-free withdrawals from their RRSPs in order to finance full-time training or education for themselves, their spouses or common-law partners. The maximum total withdrawal is $20,000, subject to a yearly maximum of $10,000. To qualify for a withdrawal, the student must meet all four conditions:

1. The student or their spouse or common law partner has an RRSP.
2. The student is a resident of Canada.
3. The LLP student is enrolled (or has received an offer to enroll before March following the calendar year of the withdrawal):
    a. as a full-time student (or if the LLP student meets one of the disability conditions, they can be enrolled on a part-time basis);
    b. in a qualifying educational program;
    c. at a designated educational institution.
4. If an LLP withdrawal was made for this student in a previous year, the repayment period has not begun.

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Assuming the qualifications for LLP withdrawals are met, withdrawals from an individual's RRSP can continue until January of the fourth calendar year after the year of when the first LLP withdrawal was made.
In order to maintain the tax-free status of the withdrawals, the money withdrawn must be repaid into the individual's RRSP account within 10 years from when payments start. The annual payment due is based on 1/10 of the total amount withdrawn until there is no LLP balance remaining. Furthermore, if more than the annual payment due is paid, the annual payment due for the following years will be reduced.

The repayment period is determined by verifying if the LLP student is a qualifying student for at least 3 months during the year. If this condition is not met for 2 consecutive years, then a minimum repayment is due for the second of those 2 years. If the condition of 3 months of enrolment continues to be met every year, then repayments start in the fifth year following the first withdrawal. Payments due for a specific calendar year can be made within 60 days following the calendar year end.

An LLP Statement of Account will be provided with the student's notice of assessment, or notice of reassessment, and reports the amount the CRA believes needs to be repaid the following year.

Example

Keith has decided to return to school and withdrew $10,000 in 2022 for his accelerated program. Keith is a qualifying student up to the end of tax year 2022. Keith's repayment period would begin in 2024, and his payments would be calculated as $10,000 / 10 years = $1,000 per year.

RRSP Maturity Options

Investors must terminate, or convert, matured RRSPs by December 31st of the year in which they turn age 71. In that year, they must choose among the following four options for their RRSPs:

- withdraw the funds as a lump sum
- purchase a registered life annuity
- purchase a registered term annuity
- transfer the RRSP funds to a registered retirement income fund (RRIF)

Recall that all money withdrawn from an RRSP is subject to income tax. If an individual takes a lump sum withdrawal of their entire RRSP, taxes are due immediately on the full amount. From a tax perspective, it is better to spread out the tax effect by purchasing an annuity or transferring RRSP funds to a RRIF. In addition, the options listed above are not mutually exclusive, so investors can customize their matured RRSP options to suit their lifestyle needs. Potential OAS and other benefit claw backs should also be considered whenever making withdrawals.

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Registered Annuities

A matured RRSP can be used to purchase a registered life annuity or a registered term certain annuity.
A registered life annuity provides a lifelong, steady stream of income to the annuitant, the main advantage being that the annuitant cannot outlive his or her retirement income payments. On the other hand, once an investor purchases a registered life annuity, they no longer have control over the investments. As a result, they must be prepared to make decisions with respect to the registered life annuity at the time of purchase. The table below lists some of the decisions that the annuitant must consider.

Decision Required	Key Considerations
How frequently do I want to be paid?	Should I take payments monthly, quarterly, or some other frequency?
Should I purchase a joint-life annuity?	Does the annuity need to provide an income for me and my spouse, or just myself?
Should my annuity payments be indexed for inflation?	Does my income need to be protected against the effects of inflation? By how much does an indexed payment lower the amount that I will receive now?
For how long should my annuity payments be guaranteed, if at all?	By how much does a guarantee period of 5 to 25 years lower the amount that I will receive now?
When should I begin to receive annuity payments?	Do I have other sources of retirement income that will allow me to defer my annuity payments to the future?
How much should the joint annuitant receive after the death of the primary annuitant?	Should the joint annuitant receive 100%, 60%, or some other amount, of what the primary annuitant was receiving?

A registered term certain annuity provides a steady stream of income to the annuitant for a specified number of years. For example, a 10-year term certain annuity provides income payments for 10 years. The main disadvantage of this type of annuity is that an individual can outlive their retirement income payments.

Other Considerations for Registered Annuities

The value of the annuitant's RRSPs, the annuitant's age, sex, and health, and the current interest rate offered by the financial institution are also important factors in the calculation of a registered life annuity payout. The annuitant's age, sex, and health are used to estimate how long the insurer will be paying out funds. For example, a younger annuitant would receive lower payments than an older annuitant. Women can expect moderately lower payments than men the same age since women on average live longer than men. Also, an individual with a medical condition, which reduces his or her life expectancy, would qualify for an impaired annuity and receive increased payments. Interest rates are critical since the financial institution buys interest-bearing investments to offset its payment obligations to the annuitant. Consequently, annuity rates reflect long-term interest rates.

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Example

Jian and Cui are ready to retire. The couple have both reached age 71 and Cui is considering purchasing a registered life annuity with her $300,000 RRSP. As a female, Cui has a longer life expectancy than her husband, Jian, who does not have any RRSP assets. However, if Cui dies before Jian, she would like him to receive 60% of their joint benefit. The couple would like to better understand the impact on their monthly income of: 1) a single life versus a joint-life annuity, 2) indexing their annuity for inflation, and 3) having a guaranteed period of 15 years. The couple would like to purchase a registered annuity that pays a monthly income starting immediately. The financial institution uses a long-term interest rate of 5% to value its annuity payment obligation.

Indexing?	15-Year Guaranteed Period	Single Life	Joint Life
No	No	$2,368	$2,192
Yes	Yes	$1,734	$1,687
Yes	No	$2,009	$1,846
No	Yes	$2,054	$2,009

If Cui wants to maximize her personal monthly registered life annuity income, she should choose a single life, non-indexed annuity with no guaranteed period. On the other hand, a joint life, indexed annuity with a 15-year guarantee period ensures that Jian will receive benefits if he lives longer than Cui, their income will keep pace with inflation, and they will receive 15 years of income.

Registered Retirement Income Fund (RRIF)

A registered retirement income fund (RRIF) is essentially a mirror of an RRSP. Whereas an RRSP is used to save money for retirement, a RRIF is used to withdraw the money accumulated as a retirement income payment. A RRIF can hold the same qualified investments as an RRSP. Like an RRSP, the growth of your investments in a RRIF is tax-sheltered and you control the investment decisions.

The major differences between an RRSP and a RRIF are that:

1) a RRIF must distribute assets in the form of a retirement income, and

2) contributions to a RRIF are not allowed.

Once an individual transfers their RRSP to a RRIF, they must withdraw a minimum amount each year. In the initial year of a RRIF, the individual is not required to withdraw a payment. When a RRIF is established, the annual minimum can be based on the annuitants age, or his or her spouses age. Once this designation is made it cannot be changed except by transferring to a new RRIF.

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They may delay the withdrawal until the following year. The amount of the minimum withdrawal is based on the RRIF balance as of December 31st of the previous year and age of the annuitant or their spouse, depending on how it was established. While there is no minimum age for starting a RRIF, an individual can postpone establishing one until the end of the year in which they turn 71. In some cases, additional or off-schedule withdrawals may be permitted. Since there is no maximum withdrawal limit, individuals are free to withdraw any amount they wish. However, RRIF payments are taxable and must be recorded as income on their income tax returns.

Example

Dag, age 71, transferred all his RRSP assets to a RRIF in November 2020 through an in-kind contribution. On December 31st, 2020, the market value of his RRIF assets was $400,000. Dag must make a minimum withdrawal from his RRIF by December 31st, 2021. The amount of his withdrawal will be based on the $400,000 market value established at the end of the previous year and his current age of 72.

Qualifying versus Non-Qualifying RRIFs

Prior to age 71, the minimum withdrawal from a RRIF is determined as follows:

Minimum Withdrawal = Market Value of RRIF Assets ÷ (90 - Age)

As of 71 years old the minimum withdrawal from a RRIF is determined as follows:

Minimum Withdrawal = Market Value of RRIF Assets x RRIF Factor

Starting at age 71, the minimum withdrawal required depends on whether the RRIF is a qualifying or non-qualifying RRIF. A qualifying RRIF is one that must have been set up in 1992 or earlier, and that contains no assets transferred or contributed to it at any time after the end of 1992 except from another qualifying RRIF. All other RRIFs are non-qualifying RRIFs.

For age 71, withdrawals from a qualifying RRIF are lower than those from a non-qualifying RRIF. For all other ages, the withdrawals are the same. The table below summarizes the age and corresponding RRIF Factor for each type of RRIF.

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Age	Non-Qualified RRIF Factor	Qualified RRIF Factor (Established Pre-1993)
70	1 / (90-age)	1 / (90-age)
71	0.0528	1 / (90-age)
72	0.0540	0.0540
73	0.0553	0.0553
74	0.0567	0.0567
75	0.0582	0.0582
76	0.0598	0.0598
77	0.0617	0.0617
78	0.0636	0.0636
79	0.0658	0.0658
80	0.0682	0.0682
81	0.0708	0.0708
82	0.0738	0.0738
83	0.0771	0.0771
84	0.0808	0.0808
85	0.0851	0.0851
86	0.0899	0.0899
87	0.0955	0.0955
88	0.1021	0.1021
89	0.1099	0.1099
90	0.1192	0.1192
91	0.1306	0.1306
92	0.1449	0.1449
93	0.1634	0.1634
94	0.1879	0.1879
95 and up	0.2000	0.2000

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Example

Sue transferred her RRSP assets to a RRIF in 2020. On December 31st of that year, Sue's RRIF assets had a market value of $300,000. Sue is 72 years old in 2021. Her minimum RRIF withdrawal for 2021 would be $16,200, calculated as $300,000 x 0.0540.

Transfers to Annuity or RRIF

The decision to transfer matured RRSP assets to an annuity or a RRIF is not simple. Both options offer several advantages and disadvantages. The table below highlights the main differences and similarities.

	Single Life Annuity	Term Annuity	RRIF
Am I guaranteed to receive a lifetime income?	Yes	No	No
Do I maintain control over my assets?	No	No	Yes
Do I have control over my investment options?	No	No	Yes
Can I run out of money before I die?	No	Yes	Depends on performance of investments.
Will my income increase with inflation?	Only if you specify an indexed annuity payment when you purchase the annuity.	Only if you specify an indexed annuity payment when you purchase the annuity.	Depends on performance of investments.
Can you increase your withdrawals?	No	No	Yes
Can I convert my life annuity to a RRIF?	No	No	Not applicable
Can I convert my RRIF to a life annuity?	Not applicable	Not applicable	Yes

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Death Considerations for Transfers to Annuity or RRIF

The table below highlights the main differences and similarities between annuities and RRIFs in cases of death.

	Single Life Annuity	Term Annuity	RRIF
What if I die before reaching my life expectancy?	If you die before the end of your guarantee period, payments continue to your estate; otherwise, payments stop.	If you die before the end of the term, a lump sum payment will be made to your estate.	The before-tax value of your RRIF may be rolled over to your spouse otherwise, the after-tax value of your RRIF assets transfer to your beneficiaries. Special rules may apply in the case of dependent children.
Could my spouse receive my annuity payments or RRIF assets if I die first?	Only if you specify a joint life annuity when you purchase the annuity.	Only if you die before the end of the term and you name your spouse as your beneficiary.	Yes

Example

Derek's spouse Laura had a 15-year term annuity policy at the time of her death, with 5 years left. Because there was 5 years remaining on Laura's term annuity, the lump sum calculation of the remaining balance of the annuity will be paid to Laura's estate.

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Lesson 4: Locked-In Accounts

Introduction

Locked-in RRSPs (LRSPs) and Locked-in Retirement Accounts (LIRAs) provide a vehicle that enables employees who leave a company with pension benefits to transfer the funds. In this lesson, you will learn about LRSPs and LIRAs, and the rules surrounding them.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- discuss why monies are required to be in locked-in accounts
- explain locked-in RRSPs (LRSPs) and locked-in retirement accounts (LIRAs)
- explain locked-in retirement funds (LRIFs) and life income funds (LIFs)

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Locked-In RRSPs (LRSPs) and Locked-in Retirement Accounts (LIRAs)

Recall that a registered pension plan is a benefit program offered by some employers to provide their employees with a pension at retirement. However, some employees will leave their company before retirement. In this case, the employee has several options with respect to their registered pension plan (RPP).

Employees can:

- forfeit the employer contributions, and receive their own contributions plus any investment earnings on those deposits

- leave their money in the plan and collect a pension from the pension plan when they reach normal retirement age, often defined as age 65

In addition:

- if the individual's new employer has an RPP, the employee may be able to transfer their money to the new employer's RPP

- if the employee is under age 55, they may be able to transfer the pension benefits to a locked-in RRSP (LRSP) or a locked-in retirement account (LIRA) depending on legislation

Employees can transfer the money they have contributed to the plan plus any investment earnings on those deposits. In addition, employees will be able to transfer the employer's deposits plus investment earnings if they have been with the employer for a certain length of time, usually two years. An employee's right to the employer's deposits and investment earnings is known as vesting. Vesting refers to the employee's right to keep any employer contributions made and investment growth earned on behalf of the employee.

Benefits from a registered pension plan must be used to provide employees with a retirement income when they reach normal retirement age, defined as age 65. LRSPs and LIRAs are similar to RRSPs, with two key differences. First, deposits to a LRSP or a LIRA can only come from a transfer of RPP assets; Employees cannot make regular contributions to these account types. Second, withdrawals from an LRSP or a LIRA are restricted since pension legislation requires that these account types be used for the sole purpose of providing employees with an income at retirement.

Although LIRAs were introduced to replace LRSPs, LRSPs are still available in federal jurisdictions. Otherwise, LIRAs and LRSPs are virtually identical in structure.

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Life Income Funds (LIFs) and Locked-in Retirement Income Funds (LRIFs)

Individuals must convert their LRSP or LIRA by December 31st of the year in which they turn age 71. In that year, they must choose among the following four options for their LRSPs or LIRAs:

- purchase a registered life annuity
- transfer your LRSP or LIRA funds to a life income fund (LIF)
- transfer your LRSP or LIRA funds to a locked-in retirement income fund (LRIF)
- transfer your LRSP or LRA funds to a prescribed retirement income fund (PRIF)

Recall that withdrawals from an LRSP or a LIRA are restricted since pension legislation requires that these account types be used for the sole purpose of providing individuals with an income at retirement. As such, most of the transfer options mentioned above include a provision that places a maximum limit on the amount that you may withdraw during a calendar year. The PRIF option is the only option where an individual can withdraw the entire account balance at any time. In other words, registered pension plan assets that end up in a PRIF account may be cashed in.

Transfer Options LIFs, LRIFs and PRIF

The transfer option your client can choose depends on the provincial or federal jurisdiction where the plan was set up. The table below provides an overview the provincial and federal jurisdictions and each option available.

Pension Jurisdiction	Life Annuity	LIF	LRIF	PRIF
Alberta	x	x	x	
British Columbia	x	x		
Manitoba	x	x	x	
New Brunswick	x	x		
Newfoundland and Labrador	x	x	x	
Nova Scotia	x	x		
Ontario	x	x	x	
Prince Edward Island				
Québec	x	x		
Saskatchewan				x
Federal	x	x		

Notice from the table above that PEI has no locking provision with respect to pension plans. In other words, there is no restriction placed on withdrawal amounts for pension plans that are administered according to the Pension Act in the province of PEI.

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The calculation for the minimum withdrawal amount that must be made from a LIF, LRIF, or PRIF account is identical to the minimum withdrawal calculation for a non-qualifying RRIF. The maximum withdrawal amount for a LIF or LRIF is determined by the provincial or federal jurisdiction where the plan was set up. In addition, the maximum withdrawal amount will vary according to the owner's age, current long-term interest rates, and the previous year's investment returns for the fund. In some jurisdictions, a LIF must be converted to a life annuity at age 90.

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Summary

Congratulations, you have reached the end of Unit 9: Retirement.

In this unit you covered:

- Lesson 1: Government and Employer Plans
- Lesson 2: Registered Retirement Savings Plans (RRSPs)
- Lesson 3: Withdrawing from RRSPs
- Lesson 4: Locked-In Accounts

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 9 **Quiz** button.

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Unit 10: Taxation

Introduction

When working with your clients on investment planning, it is important that you understand how taxation will impact their investments and financial standing. In this unit, you will learn about the Canadian tax system. You will also become familiar with the rules surrounding taxation of investment income and learn about how investment funds are taxed.

This unit takes approximately 1 hour to complete.

Lessons in this unit:

- Lesson 1: Canadian Tax System
- Lesson 2: Taxation of Investment Income
- Lesson 3: Taxation of Investment Funds

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Lesson 1: Canadian Tax System

Introduction

When working with your clients to create financial plans and make investment recommendations, it is important to have an understanding about taxation and the impact of taxes on your clients' income and investments. In this lesson, you will learn about the Canadian Tax system.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- explain Canada's progressive tax system
- describe the difference between tax avoidance and tax evasion
- describe the key elements of the Canadian tax system including the following:
    - total versus taxable income
    - marginal and average tax rates
    - federal and provincial tax rates
    - tax deductions versus tax credits

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How Canadians are Taxed

Most adult Canadians pay taxes, in one form or another. Taxes are paid at all three levels of government: federal, provincial, and municipal. The federal tax system is administered by the Canada Revenue Agency (CRA). In addition to collecting taxes on behalf of the federal government, the CRA also collects taxes on behalf of all provinces except Québec. Municipal taxes are collected at the local level.

In general, taxes are paid on worldwide personal income and corporate income, payroll, consumer purchases, and wealth. Payroll taxes are paid to support: 1) federal spending on employment insurance and the Canada Pension Plan benefit programs, and 2) provincial spending on worker's compensation benefits for injured workers. Consumer purchases are subject to sales taxes and excise taxes. A federal sales tax, the Goods and Services Tax (GST), is payable in all provinces. A provincial or harmonized sales tax on consumer purchases is payable in all provinces except Alberta. Consumer goods such as cigarettes, alcohol, and gasoline are subject to federal and provincial excise taxes. Taxes are payable on estates and property. Estate taxes refer to the taxes payable on an individual's property after they have died; whereas property taxes are the major source of revenue for municipal governments.

Where Does it All Go?

Since the CRA collects taxes on behalf of all provinces (except Québec), one of its major functions is to make transfer payments to the provinces and the Canadians who live there. In fact, the majority of taxes collected by the CRA are returned to Canadian taxpayers, provincial governments, and other organizations through various programs.

The majority of the remaining tax dollars are used to pay for the operating costs of federal government departments, agencies, Crown corporations and other federal bodies. Finally, a significant portion of tax dollars are used to pay the interest charges on Federal government debt.

How is Tax Paid?

Income and tax are calculated on a yearly basis. Individuals are required to use the calendar year while corporations can select any calendar month as their fiscal year so long as the time period is consistent year over year and does not extend beyond 53 weeks.

As a Dealing Representative, it is important to understand the importance of tax planning as part of an overall financial strategy.

Tax Planning, Tax Avoidance, and Tax Evasion

Effective tax planning is the use of tax reduction arrangements that are consistent with the intent and spirit of the law. The terms "tax evasion" and "tax avoidance" are often used interchangeably, but they are very different concepts. Tax avoidance means the use of legal methods of reducing your taxable income or tax owed. While within the letter of the law, these actions contravene the object and spirit of the law.

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Tax evasion means the use of illegal methods to conceal income or information from tax authorities. Here is a list of activities considered to be tax evasion:

- underreporting income
- falsifying income records
- purposely underpaying taxes
- claiming illegitimate or fake business expenses
- claiming illegitimate dependents on a tax return

One of the most common tax evasion schemes involves scenarios where individuals conduct their business with cash purchases only and do not report the income.

Example

Alexa has a popular part-time business selling homemade jewelry at the local market. For the last few years, she has sold about $30,000 annually. She knows she has made some profit after covering her expenses, but she hasn't kept track. She decided not to include it in her personal taxes.

Here are some examples of some legal tax avoidance approaches:

- capitalizing on tax-advantaged retirement accounts
- full utilization of allowable deductions such as medical expenses and charitable donations;
- conversion of non-deductible expenses into tax-deductible expenditures;
- postponing the receipt of income;
- splitting income with other family members, when handled properly; and
- selecting investments that provide a better after-tax rate of return.

Example

Ben has some special medical expenses he would like to claim. While some of the medical expenses were covered by the provincial health insurance program, others were not including some prescription drugs. He reviews the eligibility of the prescription drugs and includes it on this year's income tax.

Since tax rules are subject to change at all levels of the government, it is very important to continuously familiarize yourself with any announced changes. That way, you can advise your clients with the most effective investment recommendations.

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Calculating Tax

To calculate tax payable, follow these general steps.

- Step 1: calculate total income by adding together sources of income
- Step 2: subtract permissible deductions (e.g. RRSP contributions)
- Step 3: calculate taxable income
- Step 4: calculate the tax payable before tax credits by applying federal and provincial tax rates
- Step 5: subtract applicable tax credits (e.g. charitable donation)
- Step 6: calculate the total tax payable

Total versus Taxable Income

A person's total income represents the sum of all income from various sources. Some of the major sources of income include employment income, commissions, some government benefits, pension income, various types of investment income, business income, rental income, and taxable benefits received from their employer. An individual's total income is not entirely subject to income taxes. In calculating taxable income, a person is allowed to make certain tax deductions from their total income. Some of the major tax deductions include pension plan contributions, RRSP contributions, union dues, childcare expenses, support payments, carrying charges, and moving expenses.

In general, taxable income is calculated as follows:

Taxable Income = Total Income – Tax Deductions

A tax deduction reduces the amount of income on which someone pays taxes. From the formula above, you can see that a $1 tax deduction reduces a person's taxable income by $1. In general, to see how much tax your clients save from a tax deduction, you need to have an understanding of marginal tax rates.

Example

Ben's total income this year is $55,000. After reviewing his financial information for the past year, Ben realizes that he has tax deductions that add up to $5,000. As a result, he determines his taxable income to be $50,000, calculated as $55,000 - $5,000.

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Marginal and Average Tax Rates

Marginal Tax Rate

The marginal tax rate represents the amount of tax that an individual pays on the next dollar of income. Marginal tax rates are usually presented in a table format. For example, the current marginal tax rates for federal income taxes are as follows:

2020 Federal Income Tax	
Taxable Income	**Marginal Tax Rates**
First $48,535 or less	15%
Over $48,535 to $97,069	20.5%
Over $97,069 to $150,473	26%
Over $150,473 to $214,368	29%
Over $214,368 and over	33%

Average Tax Rate

The average tax rate represents how much tax is payable as a percentage of income.

Average Tax Rate = (Tax Payable ÷ Taxable Income) x 100

As a Dealing Representative, you should be familiar with the concepts of average and marginal tax rates. Understanding the tax implications for your clients helps you advise them on their investment fund investment strategy.

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Example

Ben's taxable income this year is $50,000. With respect to his federal income taxes, Ben will pay tax at a rate of 15% on his first $48,535 of taxable income. He will pay tax at a rate of 20.5% on his remaining income of $1,465, calculated as $50,000 - $48,535. Ben's taxes payable will be:

$48,535 x 15% =	$7,280.25
$1,465 x 20.5% =	$300.33
Total	$7,580.58

Ben's marginal tax rate is 20.5%. That is, for every additional dollar he had earned above $50,000, he would have paid tax at a rate of 20.5%. However, most of Ben's income was taxed at the lower marginal tax rate of 15%.

The average tax rate represents how much tax is payable as a percentage of taxable income.

Average Tax Rate = (Tax Payable ÷ Taxable Income) x 100

Ben's average tax rate is 15.16%, calculated as:

Average Tax Rate = ($7,580.58 ÷ $50,000) x 100

Federal and Provincial Tax Rates

In addition to federal income taxes, a taxpayer must also pay provincial taxes. In general, marginal tax rates in every province are applied similarly to how the federal government applies its marginal tax rates. That is, as a taxpayer's income increases, the amount of income tax they pay on the next dollar of income will progressively increase. This is referred to as a progressive income tax system.

Example

Ben's taxable income this year is $50,000. With respect to his federal income taxes, Ben will pay tax at a rate of 15% on his first $48,535 of taxable income. His federal tax payable on the initial $48,535 is $7,280.25 ($48,535 x 15% = $7,280.25). He will pay tax at a rate of 20.5% on his remaining income of $1,465 ($50,000 - $48,535 = $1,465). His federal tax payable on the last $1,465 is $300.33 ($1,465 x 20.5% = $300.33). The total amount of his federal tax payable is $7,580.58 ($7,280.25 + $300.33 = $7,580.58).

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If Ben is an Alberta resident his combined marginal tax rates will be:

Taxable Income	Federal Marginal Tax		Alberta Marginal Tax		Combined Marginal Tax
First $48,535	15%	+	10%	=	25%
Over $48,535 up to $97,069	20.5%	+	10%	=	30.5%
Over $97,069 up to $131,220	26%	+	10%	=	37%
Over $131,220 up to $150,473	26%	+	12%	=	38%
Over $150,473 up to $157,464	29%	+	12%	=	41%
Over $157,464.01 up to $209,952	29%	+	13%	=	42%
Over $209,952 up to $214,368	29%	+	14%	=	43%
$214,368 up to $314,928	33%	+	14%	=	47%
Over $314,928	33%	+	15%	=	48%

Ben's provincial tax payable would be $5,000, calculated as $50,000 x 10%. Recall from the previous example, his federal tax payable was $7,580.58. His combined federal and provincial tax payable will be $12,580.58, calculated as $7,580.58 + $5,000 = $12,580.58.

Ben's average tax rate is 25.16%, calculated as:

Average Tax Rate = ($12,580.58 ÷ $50,000) x 100

Average Tax Rate = 25.16%

Notice that Ben's average tax rate of 25.16% is lower than his marginal tax rate of 30.5%. The calculation for combining marginal tax rates is similar in other provinces. However, the number of marginal tax rate categories, or brackets, will be different among provinces based on how income tax policy has changed over time in each province.

Non-Resident Tax Rates

Canada's tax system has different methods to tax non-residents and is applied to taxpayers if the following situation applies:

- the individual did not have significant residential ties in Canada and lived outside Canada throughout the year, except if they were a deemed resident of Canada. For example, they could be a deemed resident of Canada if they were an employee of the Government of Canada posted abroad.

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- the individual did not have significant residential ties in Canada and stayed in Canada for less than 183 days in the year. Any day or part of a day spent in Canada counts as a day. If they lived in the United States and commuted to work in Canada, they cannot include commuting days in the calculation.

- the individual was deemed not to be resident in Canada under the Income Tax Act because of the provisions of a tax treaty Canada has with another country.

Tax Deductions versus Tax Credits

Recall that a tax deduction reduces the amount of total income. On the other hand, a tax credit reduces the amount of tax payable. Tax credits are applied after all tax deductions have been made and tax payable has been calculated using the combined federal and provincial marginal tax rates. Tax credits can be used to reduce the federal tax payable and the provincial tax payable.

You can use this formula for calculating the average tax rate to see how tax deductions and tax credits can be used to reduce taxes.

Recall,

Average Tax Rate = (Tax Payable ÷ Taxable Income) x 100

A tax deduction will reduce total income. A tax credit will reduce tax payable, the numerator. In either case, the average tax rate will decrease.

Example

Jose's taxable income this year is $100,000 and he pays tax at an average tax rate of 40%. The following table compares a $5,000 tax deduction with a $5,000 tax credit.

	Deduction	Tax Credit
Income	$100,000	$100,000
Tax Deduction	($5,000)	n/a
Taxable Income	$95,000	$100,000
Tax @ 40%	$38,000	$40,000
Tax Credit	n/a	($5,000)
Tax Payable	$38,000	$35,000

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From this comparison, we can see that a $5,000 tax credit reduces our tax payable more than a $5,000 tax deduction. The example above is highly simplified to illustrate the difference between a tax credit and a tax deduction. Whether one is more advantageous than the other will depend on an individual's own situation. For instance, if you make a large RRSP contribution, the resulting tax deduction could mean your net income is in a lower tax bracket. In this case, a tax deduction may be more advantageous than a tax credit.

Types of Tax Credits

There are two types of tax credits:

- refundable
- non-refundable

Refundable credits are tax credits that are paid directly to individuals, if they are not needed to reduce their tax payable. For example, Terence has $200 in taxes owing and a refundable tax credit of $500, he will receive a $300 refund from the CRA, calculated as $500 - $200. The most common refundable tax credit is the GST tax credit.

Non-refundable credits are tax credits that can only be used to reduce the tax payable. Once an individual has no tax payable, certain non-refundable tax credits may be transferred or carried forward to future tax years. The table below lists those non-refundable tax credits that may be transferred to other individuals, usually a spouse or blood relative, or carried forward by the individual.

Transferable Tax Credit Amounts	Tax Credit Amounts Eligible for Carry Forward
• Tuition, education, and textbook amount • Pension income amount • Age amount • Disability amount	• Medical expenses amount • Tuition, education, and textbook amount • Charitable contribution amount

Other Non-Refundable Tax Credits

Some other common federal and provincial non-refundable tax credit amounts include:

- Basic personal amount
- Spouse or common-law partner amount
- Amount for an eligible dependant

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- CPP contributions
- Employment insurance premiums
- Canada employment amount
- Children's fitness amount (only available in certain provinces and territories)
- Interest paid on your student loans

Tax Credit Calculation

Recall that tax credits are applied after all tax deductions have been made and tax payable has been calculated. In order to determine the amount by which tax credits reduce tax payable, a person must add up their tax credit amounts and multiply the amount by the lowest marginal tax rate.

The tax credit calculation is performed separately for federal tax payable and provincial tax payable. As a result, individuals multiply their total federal tax credit amounts by 15% and their total provincial tax credit amounts by the lowest marginal tax rate in their respective provinces.

Example

Ben's taxable income this year is $50,000. Ben's provincial tax payable is $5,000, and his federal tax payable is $7,580.58. However, Ben has eligible amounts of $15,000 that can be used for federal tax credits and $20,000 in eligible amounts for provincial (Alberta) tax credits. Ben will be able to reduce his tax payable as follows:

- Federal tax payable: $7,580.58 – ($15,000 x 15%) = $5,330.58
- Provincial tax payable: $5,000 – ($20,000 x 10%) = $3,000

After taking into consideration his non-refundable tax credits, Ben's average tax rate is 16.66%, calculated as:

Average Tax Rate = ($5,330.58 + $3,000) ÷ $50,000 x 100

Average Tax Rate = 16.66%

Although Ben's average tax rate has decreased to 16.66%, his combined federal and provincial marginal tax rate is still 30.5%.

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Lesson 2: Taxation of Investment Income

Introduction

As a Dealing Representative, your clients will expect you to know how taxation will affect their investment income. In this lesson, you will learn about the differences in how registered and non-registered accounts are taxed. You will also learn about the tax treatment for different types of income.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- differentiate between the taxation of registered and non-registered accounts
- describe the tax treatment for interest income
- describe the tax treatment for Canadian dividend income
- describe the tax treatment for other income including foreign income
- describe the tax treatment for capital gains and capital losses

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Taxation of Registered and Non-registered Accounts

Recall that registered accounts are savings plans that are defined in the federal *Income Tax Act*, registered with the Canada Revenue Agency (CRA), and administered by various financial institutions. These types of plans are granted special tax status wherein contributions may be tax deductible and taxes payable on any investment earnings may be deferred. There are also a number of limitations and restrictions on these plans including how withdrawals are treated for tax purposes. The main types of registered accounts are:

- tax-free savings account (TFSA)
- registered education savings plan (RESP)
- registered retirement savings plan (RRSP)
- registered retirement income fund (RRIF)
- registered disability savings plan (RDSP)

Table: Tax Implications

The table below highlights the tax implications of contributions, investment earnings, and withdrawals for these registered accounts.

Type of Account	Are Contributions Tax Deductible?	Are Investment Earnings Taxable Every Year?	Are Withdrawals Tax-Free?
Tax-free Savings Account (TFSA)	No	No	Yes
Registered Education Savings Plan (RESP)	No	No	Educational Assistance Payments (EAP) withdrawals and withdrawals from the investment returns are taxable; withdrawals of subscriber contributions are tax-free
Registered Retirement Savings Plan (RRSP)	Yes	No	No
Registered Retirement Income Fund (RRIF)	N/A	No	No

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Type of Account	Are Contributions Tax Deductible?	Are Investment Earnings Taxable Every Year?	Are Withdrawals Tax-Free?
Registered Disability Savings Plan (RDSP)	No	No	Disability Assistance Payments (DAP) withdrawals and withdrawals from the investment returns are taxable; withdrawals of contributor contributions are tax-free

There are no particular tax benefits associated with non-registered accounts. Contributions are not tax-deductible and investors must pay tax on the plan's investment income as they earn it.

Types of Income

Depending on the types of investments held within a registered or non-registered account, the types of income that may be earned include the following:

- interest income
- Canadian dividend income
- other income, such as income from foreign property
- capital gains or losses

Interest Income

Interest income refers to investment income that is earned on: 1) cash that is deposited in a chequing or savings account, and 2) various types of debt securities, such as treasury bills (T-Bills), Canada Savings Bonds, term deposits, and guaranteed investment certificates (GICs). Interest income is fully taxed at the investor's marginal tax rate. In addition, the tax payable on interest income is due in the year in which it is earned.

Example

Lina owns a one year fixed-rate Guarantee Investment Certificate (GIC) of $5,000 that will pay 2% or $100. Lina must pay taxes on the interest income at her marginal tax rate.

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Dividend Income

Dividend income refers to investment income that is paid out of the after-tax net income of a corporation to its shareholders. Like interest income, the tax payable on dividend income is due in the year in which the dividend is received.

The tax treatment of dividends will depend on the answers to the following questions:

- Is the dividend from a Canadian corporation or a foreign corporation?
- If the dividend is from a Canadian corporation, is the corporation a large public Canadian corporation or a Canadian–controlled private corporation (CCPC)?

A dividend paid by a foreign corporation is referred to as a foreign dividend and is fully taxable at the individual's marginal tax rate. A dividend paid by a large public Canadian corporation is referred to as an eligible dividend. A dividend paid by a Canadian-controlled private corporation is referred to as a non-eligible dividend. Eligible and non-eligible dividends are taxed at a lower rate than foreign dividends. The mechanism for this reduced tax payable is referred to as the dividend gross-up and tax credit.

Dividend Gross-Up and Tax Credit Mechanism

Non-eligible gross-up and dividend tax credits considerations have changed as of January 1, 2019. The tax payable on eligible and non-eligible dividends can be determined using the following table:

Federal Dividend Tax Credit		
Gross-Up and Tax Credit	**Eligible Dividend (2012 and later)**	**Non-Eligible Dividend (As of 2019)**
Gross-Up	38%	15%
Dividend tax credit as % of grossed-up dividend	15.02%	9.03%

In order to compute the federal tax payable on dividend income, the dividend is multiplied by the gross-up percentage to get the grossed-up taxable dividend. Tax payable is then calculated by multiplying the investor's marginal tax rate and the grossed-up taxable dividend. Next, the grossed-up taxable dividend is multiplied by the respective dividend tax credit rate. This amount is subtracted from the investor's tax payable to determine their federal tax payable.

Why the Gross-Up and Tax Credit?

Recall that dividends are paid out of the after-tax net income of the corporation. Since the corporation has already paid tax before the dividend was paid to shareholders, it would be unfair for shareholders to have to pay tax at their regular marginal tax rate on Canadian dividends. This would result in taxes being paid twice to

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the federal government. The gross-up and tax credit mechanism was designed to minimize the double taxation of dividends paid by Canadian corporations.

Note that the dividend tax credit is non-refundable. In lower tax brackets, this might result in a negative marginal tax rate for eligible individuals.

Since the federal government does not normally receive corporate income tax payments from foreign corporations, the dividends paid by these corporations are not given any special tax treatment when they are paid to Canadian shareholders.

Example

Pavel received a $1,000 eligible dividend from a large public Canadian corporation, and a $1,000 non-eligible dividend from a Canadian–controlled private corporation (CCPC). Pavel's federal marginal tax rate (MTR) is 29%. What will be his federal tax payable for each of these dividends?

	Eligible Dividend	Non-Eligible Dividend
Dividend	$1,000	$1,000
Gross-up	+$380	+$150
Taxable Dividend	$1,380	$1,150
Tax payable at 29% MTR	$400.20	$333.50
Less: Dividend Tax Credit	-$207.28	-$103.85
Federal Tax Payable	$192.92	$229.65

The federal tax that Pavel must pay on the eligible dividend he received from the large public Canadian corporation is less than the federal tax he must pay on the non-eligible dividend.

Other Income

Some other types of income include:

- interest and dividend income from foreign sources
- rental income
- partnership income
- spousal support payments
- business income

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- farming income
- fishing income

All the above types of income are fully taxable.

Foreign Investment Income

Foreign investment income is often subject to withholding tax levied by the country in which the income originates. However, the full amount of these earnings must be reported on a Canadian tax return. For example, the U.S.-Canada Tax Treaty, Articles X and XI, stipulates a 10% withholding tax on U.S. interest income, while the rate is 15% for U.S dividend income. Hence, $250 of interest income from the U.S. would be subject to $25 of withholding tax, leaving $225 in the hands of the Canadian recipient. However, the full $250 must be included in income for tax purposes.

Each unitholder is entitled to claim a foreign tax credit or deduction for taxes paid to a foreign government by an investment fund. In our example, the taxpayer would claim a foreign credit of $25.

For Canadian residents, the capital gains tax treatment is the same for foreign and domestic property. Although withholding tax is not applied to capital gains, you may be required to pay tax to the country where your investments are domiciled.

Capital Gains and Losses

A capital asset is any asset that is purchased and maintained for the purpose of generating income. Some examples of capital assets include equipment, buildings, and rental property. A capital gain results when capital assets are sold for more than their cost. Conversely, a capital loss results when capital assets are sold for less than their cost. If capital assets have not been sold, then a capital gain or loss has not been realized; this is referred to as an unrealized capital gain or loss.

For investment purposes, the cost of an investment is referred to as its adjusted cost base (ACB) which is adjusted for tax-related items such as acquisition costs, reinvested distributions, and return of capital distributions.

Capital Gain: Market Price > Adjusted Cost Base (ACB)

Capital Loss: Market Price < Adjusted Cost Base (ACB)

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Example

Uday and Oksana are active investors. Yesterday, Uday sold shares of a company for $5,000. The cost of the shares is $3,000. At the same time, Oksana sold shares of a company for $6,000. The cost of the shares is $10,000. Their respective capital gain and loss would be calculated as follows:

Uday's capital gain is $2,000, calculated as $5,000 - $3,000.

Oksana's capital loss is $4,000, calculated as $6,000 - $10,000.

Taxation of Capital Gains and Losses

In Canada, only 50%[13] of a capital gain is taxable. This amount is referred to as taxable capital gain. Similarly, only 50% of a capital loss is allowable. This amount is referred to as an allowable capital loss. Allowable capital losses may be used by a taxpayer to reduce their taxable capital gains. This will, in effect, reduce the amount of tax that they must pay.

Investors can apply allowable capital losses only against taxable capital gains, not against other sources of income. To the extent that the allowable capital losses in a given year exceed the taxable capital gains for the year, a net allowable capital loss will arise. In other words, in a given tax year, allowable capital losses can only reduce taxable capital gains to $0. However, net allowable capital losses are not lost but can be carried back three years to reduce previous taxable capital gains or carried forward indefinitely to reduce future taxable capital gains.

It is important to consider the tax consequences when making any adjustments to a non-registered portfolio which will result in a deemed disposition. A deemed disposition can result in unintended consequences (like creating unnecessary increases in taxable income). However, re-balancing a non-registered portfolio can also create tax efficiencies (like taking advantage of unrealized gains or losses). Keep in mind that this only applies to non-registered accounts since registered accounts (e.g. RRSPs and TFSAs) are already tax-advantaged.

[13] The 2024 Federal Budget increased the inclusion rate on capital gains to two-thirds (66.67%) on those that exceed $250,000 realized annually by individuals and on all capital gains realized by corporations and trusts. An equivalent increase in inclusion rate applies to capital losses. Pending Royal Assent, the increase became effective June 25, 2024. For more information, refer to this link: https://budget.canada.ca/2024/report-rapport/toc-tdm-en.html. **Note: This material is provided for information purposes only. For exam purposes, the course content will apply.**

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Example

Last year, Terry bought and sold two investment funds as follows:

	Prime Canadian Equity Fund	Optima International Fund
Cost	$11,000	$14,000
Sale Price	$5,000	$16,000
Capital Gain (Capital Loss)	($6,000)	$2,000
Taxable Capital Gain	-	$1,000
Allowable Capital Loss	($3,000)	-

Terry can use her allowable capital loss of $3,000 to reduce her taxable capital gain of $1,000 to $0. Since her allowable capital loss exceeds her taxable capital gain by $2,000, she will have a net allowable capital loss of $2,000 for the year. Terry can use this net allowable capital loss to reduce her taxable capital gains from the previous three tax years. She could also carry forward this net allowable capital loss to reduce future taxable capital gains.

Note that capital losses are handled differently in an investor's year of death or terminal return. Pursuant to s. 111 (2) of the Act, all capital losses realized in the year of death, including capital losses created as a result of the deemed realization rules, may be deducted from capital gains realized in the year.

For the year of death and the immediately preceding year, net capital losses may be used to reduce income. There is no restriction if there is a carry forward of net capital losses from a year prior to death. Those losses may also be deducted in the return prior to the terminal return.

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Lesson 3: Taxation of Investment Funds

Introduction

As a Dealing Representative, it is very important that you have a good understanding of taxation as it applies to investment funds. In this lesson, you will learn about the tax treatment of investment funds.

This lesson takes approximately 20 minutes to complete.

At the end of this lesson, you will be able to:

- describe how income distributed from investment fund trusts is taxed (flow-through)
- distinguish between capital gains derived from redemptions and those distributed by investment fund trusts
- discuss what happens to capital losses in investment funds
- describe how income is taxed in an investment fund corporation
- discuss the benefits of holding funds within a corporate structure
- discuss the tax treatment of return of capital
- discuss the year-end tax trap

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Income Distribution and Redemption of Investment Funds

Investment fund trusts don't pay tax directly. They are known as "flow-through" entities that distribute all of their taxable income to investors. It is important for investment funds to “flow-through” all their taxable income since income earned at the trust level and not distributed to unitholders is subject to taxation at the highest marginal rate.

For investment fund investors, there are two ways in which investment funds generate taxable income:

- distributions
- redemptions

A distribution occurs when interest income, dividends, and net capital gains earned on the investments within an investment fund are “flowed-through” to the investment fund investor.

Example

A portfolio manager purchases 10,000 shares of TUX Ltd. in January for $100,000. In October, the portfolio manager sells all the shares for $150,000. In December, they distribute the $50,000 capital gain to all unitholders, calculated as $150,000 - $100,000.

A redemption occurs when the investment fund investor sells units of the investment fund. If the market price is greater than the cost of the investment fund, the investor realizes a capital gain.

Example

An investor purchases $5,000 of the Premia Canadian Equity Fund in January. In December, the investor sells the investment fund for $6,000. From the sale, the investor has a capital gain of $1,000, calculated as $6,000 - $5,000.

Capital Losses and Investment Funds

Capital losses are not distributed by investment funds. Instead, capital losses are used to offset realized capital gains within the investment fund. As a result, the distribution of a capital gain to unitholders is referred to as a net capital gain. An investor’s portion of a distributed net capital gain is taxable.

If an investment fund has a greater amount of capital losses than capital gains, the remaining net capital losses may be carried back three years or carried forward indefinitely. Since investment funds distribute all their income, dividends, and net capital gains every year, capital losses of an investment fund are never carried back.

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Example

Earlier this year, the fund manager for Equinox Canadian Equity Fund sold 50,000 shares of MED Ltd. And 100,000 shares of TAL Ltd. The fund realized a taxable capital gain of $25,000 on the MED shares and an allowable capital loss of $30,000 of the TAL shares. As a result, the fund has a net capital loss of $5,000, calculated as $25,000 - $30,000. Since all previous capital gains have been distributed by the fund, the net capital loss will be carried forward indefinitely.

Summary: Income Distribution and Redemption

Investment fund investors may realize interest income, dividends, capital gains, and capital losses on their funds. The table below summarizes what an investor may receive in the case of a distribution or redemption.

	Interest Income	Dividends	Capital Gains	Capital Losses
Distribution	Yes	Yes	Yes	No
Redemption	No	No	Yes	Yes

Reporting of Investment Fund Trust Income

The income generated from an investment fund trust is reported on a T3 Slip – Statement of Trust Income Allocations and Designations. These slips are mailed to unitholders on or before March 31, informing them of the amounts of each type of income received. Investors living in Canada must then report the income on their annual income tax returns.

For tax purposes, interest income is classified as other income, which is reported in Box 26 of the T3 Slip. Depending on whether the dividend is eligible or non-eligible dividends, the dividend gross-up, and the dividend tax credit are reported in the following boxes:

	Actual Amount	Gross-Up Amount	Dividend Tax Credit
Eligible Dividends	Box 49	Box 50	Box 51
Non-Eligible Dividends	Box 23	Box 32	Box 39

NOTE: The information provided in this table above is for information purposes only and is not testable material.

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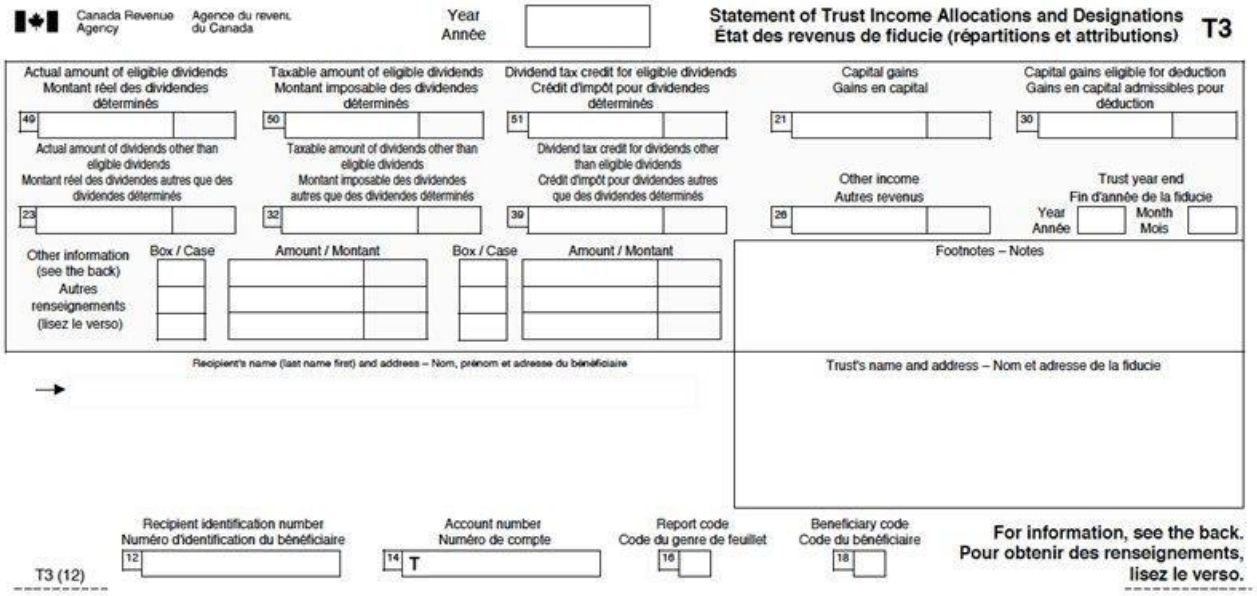
Capital gains are reported in box 21 and the non-taxable portion of capital gains is reported in Box 30. Since foreign income is not eligible for any special treatment, it is included in Box 26, other income. The exhibit below displays a T3 Slip.

Sample T3



Source : https://www.canada.ca/en/revenue-agency/services/forms-publications/forms/t3.html

Investment Fund Corporations

Unlike an investment fund trust, an investment fund corporation must file a tax return and pay tax on its investment income. It then makes additional filings with the tax authorities to retrieve the tax paid which enables it to ultimately flow-through income to unitholders. Only Canadian dividends and capital gains can be flowed through to investment fund corporation unitholders.

There is no refund of tax paid for interest and foreign income earned within the investment fund corporation. These can only be distributed to unitholders after tax in the form of a taxable Canadian dividend.
The income generated from an investment fund corporation is reported on a T5 Slip – Statement of Investment Income.

Corporate Class Investment Funds

Most Canadian investment funds are structured as trusts, but some are structured as corporations. There are two benefits to corporate class investment funds. The first is potentially lower taxable distributions resulting in tax deferral. This is beneficial when investing in a non-registered personal or corporate account. The second is that only capital gains and Canadian dividends flow through the investment fund corporation, reducing the amount of interest income earned in a comparable trust version of a similar investment fund. This can make your client's after-tax income higher.

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Return of Capital

An investment fund can make distributions to unitholders which are not derived from income, dividends, or capital gains earned within the fund's portfolio. This type of payment is a "return of capital" for income tax purposes, sometimes called a capital dividend (though the payment is not derived from dividend income).

A return of capital distribution is distinctly different than a regular dividend derived from preferred or common shares. Dividends are paid from a corporation's retained earnings (i.e. the corporation's after-tax profit). However, a return of capital distribution is not derived from dividends, capital gains, or other income generated from the underlying investments within the fund. Rather, a return of capital distribution represents a payment made from the investment capital held within the fund on behalf of unitholders. In essence, the unitholders' investment capital is paid back, or "returned", to them as a distribution payment.

As with all other types of distributions, the net asset value per unit (NAVPU) is reduced by the amount of the distribution when a return of capital is paid. In addition, a return of capital distribution will also reduce the original cost of the units (also known as the adjusted cost base) when the fund is held in a non-registered account.

A return of capital distribution is not taxable when it is paid to the investor nor reported on the T3 Slip issued by the fund to the investor. However, a capital gain (or loss) will be realized when the investor eventually redeems the units. The capital gain will be greater (or the capital loss smaller) when a return of capital has been paid because the adjusted cost base was reduced.

Example

Nikos paid $1,000 to purchase 100 units of High Peaks Fund at a price of $10.00 per unit. At the end of the year, the fund paid a distribution of $1.00 per unit for a total amount of $100 ($1.00 x 100). The distribution per unit consisted of $0.50 in dividends from taxable Canadian corporations, $0.30 as interest income, and $0.20 as a return of capital. The return of capital reduced the adjusted cost base of Nikos' fund by $0.20 per unit, to $9.80. When the fund is sold, the lower adjusted cost base will increase the amount of the capital gain by $0.20 per unit.

While return of capital distributions will not be reflected on the investor's T3 Slips, they will be reflected on the investor's monthly or quarterly statements.

Year-end Tax Trap Scenario 1

Most investment funds distribute their capital gains and income in December. All registered unitholders that own a fund before the ex-dividend date receive the distribution. If your client purchases an investment fund just before the ex-dividend date, you have a tax liability for that year even though the total value of their holdings is the same as before the distribution.

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Example

On December 30, Sami invested $1,000 in a no-load investment fund with a net asset value per unit (NAVPU) of $20. As a result, he received 50 units, calculated as $1,000 ÷ $20 per unit.

On December 31, the fund paid out a capital gains distribution of $1 per unit when the NAVPU was still $20. This had the effect of reducing the NAVPU to $19, calculated as $20 - $1.

As a result, Sami now held 50 units of the fund worth $19 each for a total of $950, calculated as $19 per unit x 50 units. In addition, Sami now has a pre-tax capital gains distribution of $50, calculated as 50 units x $1 per unit. Sam's pre-tax wealth is still $1,000 but it is now split between $950 worth of investment funds and $50 in capital gains.

Even though Sami has only held units in the investment fund for one day, he has already incurred a taxable capital gain of $25, calculated as $50 x 50%. Had Sami waited until January 1, the NAVPU would have dropped to $19. He would have had invested his $1,000 and received 52.63 units, calculated as $1,000 ÷ $19 per unit. By delaying his purchase, he would have avoided an immediate taxable capital gain.

Year-end Tax Trap Scenario 2

If an investment fund does not distribute capital gains and income in December, the year-end tax trap will still exist. In this case, there is still a distribution, but the money is immediately reinvested in the fund. As a result, the investor will own more units of the investment fund, but each unit will be worth less.

Example

On December 30, Sami invested $1,000 in a no-load investment fund with a net asset value per unit (NAVPU) of $20. As a result, he received 50 units, calculated as $1,000 ÷ $20 per unit. Suppose that instead of paying out a $1 per unit capital gains distribution to Sami, the investment fund manager reinvests the capital gains within the fund. Sami would still receive a distribution worth $50, calculated as 50 units x $1.

As a result, Sami’s investment fund units would now be worth $950, calculated as $1,000 -$50. In addition, the NAVPU would decrease to $19 per unit, calculated as $950 ÷ 50 units.

However, since the capital gains were reinvested, Sami will instead receive additional units in the investment fund. Sami will now own 52.6316 units of the investment fund, calculated as $1000 ÷ $19.

Sami has a realized capital gain of $50, calculated as (52.6316 - 50) x $19. In effect, Sami has used his distribution to purchase an additional 2.6316 units of the investment fund.

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Year-end Tax Trap Scenarios Compared

The table below summarizes the year-end tax trap scenarios. The difference between the two scenarios is that Sami would have received $50 in scenario 1, whereas he would have reinvested $50 in scenario 2.

	Scenario 1 Year-end Capital Gains Distribution	Scenario 2 Year-end Capital Gains Reinvestment
Units Owned	50	52.6316
NAVPU	$19	$19
Market Value of Investment	$950	$1,000
Realized Capital Gain	$50	$50

An investor should exercise caution when purchasing units of an investment fund near the end of the year if the fund will be paying capital gain distributions. Waiting until January 1 of the following year to purchase shares will ensure there is no unnecessary taxable capital gains tax.

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Summary

Congratulations, you have reached the end of Unit 10: Taxation.

In this unit you covered:

- Lesson 1: Canadian Tax System
- Lesson 2: Taxation of Investment Income
- Lesson 3: Taxation of Investment Funds

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 10 **Quiz** button.

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Unit 11: Making Recommendations

Introduction

As a Dealing Representative, you must follow a rigorous process to satisfy your obligations to your clients when making recommendations. This starts with gaining a thorough understanding about each client's personal and financial circumstances, identifying their investment needs and goals, and then recommending investments that will best help them achieve their objectives.

This unit takes approximately 1 hour and 15 minutes to complete.

Lessons in this unit:

- Lesson 1: Evaluating the Client
- Lesson 2: Selecting Investment Funds
- Lesson 3: Asset Allocation
- Lesson 4: Tax Efficient Strategies

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Lesson 1: Evaluating the Client

Introduction

As a Dealing Representative, you must follow a rigorous process to satisfy your Know Your Client (KYC) obligation. In doing so, you are required to learn and understand the essential facts about each client. You have a regulatory obligation to *know* the client, *know* the product, and to form an opinion as to whether the investment product or strategy is suitable for the client. In this lesson you will review your requirements under the suitability obligation, with a focus on how to best work with your client to obtain the required information. You will also learn about selecting investment funds, allocating assets, and applying the "Client's Interests First" standard when making recommendations.

This lesson takes approximately 35 minutes to complete.

At the end of this lesson, you will be able to:

- understand the importance of building trust and communicating with clients
- describe the benefits of situational questioning in obtaining Know Your Client (KYC) information
- demonstrate how to determine:
  - personal circumstances
  - financial circumstances
  - investment needs and objectives
  - investment knowledge
  - risk profile
  - time horizon
- understand the Know Your Product (KYP) obligation
- understand the suitability obligation
- understand how emotions and psychological bias affect investor behaviour
- discuss some best practices for providing service to your clients

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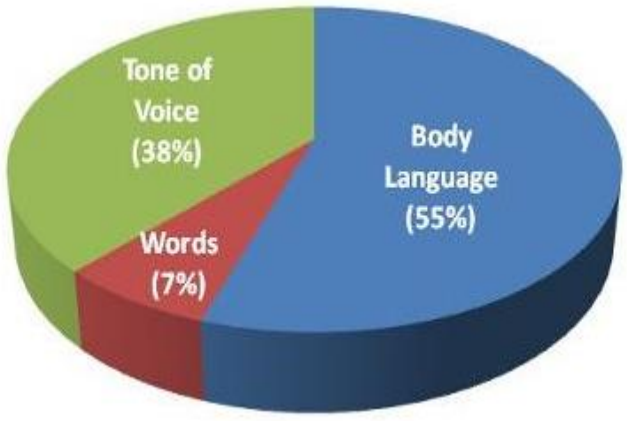
Client Communication – Words and Body Language

You don't get a second chance to make a first impression. As a result, it is important to manage your client's first impression of you. Although you often use words to communicate a message to your client, there are other aspects that are also important. These include the tone of your voice, the pace of your speech, and the volume of your voice.

Your body language also sends a message including:

- the physical space between you and your client
- your clothing and appearance
- your posture
- the gestures you make
- your facial expressions
- the eye contact you make
- any physical contact (e.g. shaking hands)



The pie chart above illustrates results from a famous study that attempted to demonstrate the importance of the three elements of face-to-face communication:

- words
- tone of your voice
- non-verbal communication

The purpose of the study was to measure the importance of these elements when forming an impression of how much we like someone when they convey a message about their feelings. As you can see from the chart, non-verbal communications plays an important role in building rapport.

Client Communication - Listening Skills

Effective client communication also requires you to have effective listening skills. This means that you must actively listen to the message that a client is communicating. Active listening involves hearing, understanding, and interpreting what the client is saying before you respond. It is also important to pay attention to what your client says, i.e. their words; and how they say it, i.e. the tone of their voice and their body language. Sometimes, what a client does not say is just as important as what they do say. Therefore, you should encourage your client to fully describe their personal situation. Your client must have the impression that you want them to fully disclose and describe what they have on their mind.

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Building Trust

Building trust is the first step towards gaining an understanding about your client. Allowing the client to express themselves and their concerns means that you must try to avoid talking too much. If you must talk, try to avoid asking questions related to your product or service. Instead, ask situational questions to gather as much information as the client is comfortable providing about their current circumstances. A client is more likely to answer questions if they have the impression that you genuinely care and are interested in them and their priorities.

Some examples of situational questions include:

- What are your financial goals right now? What are your future financial goals?
- Do you see yourself in your current career five years from now?
- What is your current income?
- Are you able to comfortably cover your monthly expenses?
- Is it important for you to travel when you take time off from work? Where do you like to go?
- Do you have enough money left at the end of the month to put towards your financial goals?
- Do you have a plan to pay off your debt quickly?
- What options have you considered for saving towards your children's post-secondary education?
- Do you have a pension plan at work? A registered retirement savings plan (RRSP)?
- How long do you want to work?
- How much money would you like to receive annually once you semi-retire or retire?

Identifying Problems

The purpose behind asking situational questions is to help clients uncover any problems that may prevent them from reaching their goals. However, identifying a problem is not the same as wanting to act to address it in some way. A problem can only be addressed if a client explicitly indicates that he or she wants to act to fix the problem. In other words, the client expresses an explicit need to address the problem. On the other hand, a client who expresses dissatisfaction or concern may not be ready to address the problem. In this case, the client is said to have an implied need.

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Example

Amber, a new Dealing Representative, interviews a potential client for the first time named Aziz. During the meeting, Aziz tells Amber that he is very concerned about the future cost of his children's education. Amber recognizes that Aziz is only expressing an implied need. Amber asks Aziz a question regarding the implication of the increasing cost of education.

Aziz tells Amber that his children may not be able to go on to post-secondary education if the cost is too high and they don't have adequate financial resources. During this part of the interview, Aziz indicates that he would like to save for the future cost of his children's education. At this point, Aziz has indicated that he has an explicit need to act to address the problem.

Offering Solutions

One aspect of the role of a Dealing Representative is to help clients address their problems by helping clients realize the implications of not acting on them. If a client is concerned about the cost of their children's education, it is the role of the Dealing Representative to help the client understand that not acting to address the problem may result in added financial strain on the client's or children's finances when it is time for the children to go to college or university. If a Dealing Representative does not take the time to ask the right situational questions to uncover potential problems, the client may have larger problems in the future or the client may find another Dealing Representative who is better able to understand the client's needs.

Example

Amber recognizes that Aziz would like to find a solution to the problem of the increasing cost of education and what it could mean for the future of his children's education. Aziz is happy that Amber is able to offer a number of options. After providing Aziz with the features and benefits of each option presented, Amber and Aziz work together to determine which solution will best meet Aziz's needs.

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Suitability Requirement

As a Dealing Representative, you have a regulatory obligation to *know* the client, *know* the product, and to form an opinion as to whether the investment product or strategy is suitable for the client.

When you are considering offering or recommending an investment product or investment strategy to a client, you are obligated to first:

- learn the essential facts about the client
- learn the essential facts about the investment product and/or investment strategy
- determine whether the investment product and/or investment strategy is suitable for the client

Under the suitability obligation, you are required to ensure that any orders you accept and any recommendations that you make are suitable based on the essential facts relative to the client. However, the suitability obligation extends beyond orders and recommendations. You are also required to make a suitability determination every time that you take any other investment action for a client.

Step 1: Know Your Client

Under the Know Your Client (KYC) obligation, you are required to collect and consider specific information to learn the essential facts about each client to ensure that clients are well served by investments that suit their individual financial needs. In order to satisfy your KYC obligation, you are expected to take reasonable steps to:

- establish the identity of the client
- ensure that you collect and consider sufficient information about the client's:
  - personal circumstances
  - financial circumstances
  - investment needs and objectives
  - investment knowledge
  - risk profile
  - time horizon

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You are also required to collect important information as required under other laws and regulations including legislation governing tax reporting, Proceeds of Crime (Money Laundering) and Terrorist Financing, and privacy.

Knowing your client involves having meaningful conversations with your clients that allow you to truly know and understand their means, needs, limitations, circumstances, finances, and investment goals. When having these conversations with your clients, it is often more effective to have a broad-ranging conversation that covers the information you are required to know, rather than simply asking blunt questions. From a compliance point of view, the more information you have about your client's situation, the better.

The following section provides suggestions about some of the types of questions that might help you to get the information you need.

KYC Criteria	Suggested Questions
Personal Circumstances	• What is your contact information and address? • What is your date of birth? • What is your marital status? • Do you have dependents? How many? • Are there any other persons who are authorized to provide instructions on the account? Who? • Are there any other persons who have a financial interest in the account? Who?
Financial Circumstances	• What is your employment status? • What is your occupation? • Is your work situation stable? • What is your income and cash flow? • What are your sources of income? • Is your level of income consistent or does it vary? • Do we need to make allowances for discrepancies in income from paycheque to paycheque? • Do you expect your current income to increase or decrease significantly in the next few years? • Do you have any financial resources that you can use to generate additional income? • What assets do you have (fixed and liquid)?

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KYC Criteria	Suggested Questions
	• What sort of savings do you have? • What debts and financial obligations do you have? • Do you have a lot of fixed expenses, or are you able to adjust your spending easily if you need to? • What are your liquidity needs from your investments? • Are you using borrowed funds to invest? • Are there any tax consequences to be considered?
Investment Needs and Objectives	• What do you want to achieve from investing? • When do you want to achieve this goal? • Do you have more than one goal? • Is your goal realistic?
Investment Knowledge and Experience	• What is your understanding about investing? • Have you ever invested before? In what types of investment products? • What do you understand about the risks of investing? • What do you understand about the relationship between risk and return? • What do you understand about the taxation of investments?
Risk Profile	• How would investment losses impact your financial circumstances? • What would happen to your financial well-being if you lost all or part of your investment? • How would you react if your investment decreased by 10%? 20%? 30%? or more? • How would you feel if you lost all or part of your investment?
Time Horizon	• What is your time horizon in relation to your investment goals? • When will you need to access the money in your investment(s)? • What would cause you to liquidate your investment(s)?
Additional Questions	• Do you have insurance of any type?

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The regulators expect you to document the questions and answers you use to establish your clients' risk profiles. Assessing a client's risk profile is sometimes determined by using tools such as questionnaires. Questionnaires can also be useful tools for learning, collecting, and considering other pertinent details about your clients. You should be fully aware of the questionnaires approved by your dealer and follow your firm's policies and procedures for determining risk profile.

Your KYC Responsibilities

Under regulatory requirements, you are expected to:

- have a meaningful interaction with the client during your KYC process
- discuss with the client their role in keeping KYC information current
- tailor the KYC process to reflect the nature of the relationship with the client
    - For example, the regulators expect that extensive KYC information will be required if you are offering an ongoing and fully customized service or an investment product or strategy that is illiquid or highly risky.

The regulators expect you to help your clients understand KYC terminology, inquire about any noted KYC responses which appear inconsistent, and provide assistance to help clients define their investment needs and objectives. You are expected to be particularly conscientious in your KYC discussions with vulnerable or unsophisticated clients.

The KYC requirement is an ongoing obligation. It does not end after the initial KYC is recorded and considered when the new account is opened. You are responsible for periodically reviewing and updating the KYC information on file for your clients.

Client Refusal

A great deal of care should be taken when obtaining the Know Your Client information. There may be situations that arise where a client refuses to provide their KYC information. However, you cannot accept client accounts or properly fulfill your suitability obligation on this basis. You must carefully and clearly explain why the KYC information is needed and how it will be used. If the client is still resistant after you have explained the need to collect this information, you need to either:

- Reject the client's business, or
- Contact your Compliance Department. They may be able to help you with explaining to the client that the account cannot be opened without obtaining the information required under regulatory requirements.

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Step 2: Know your Product

Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation.

What You Should Know

Your dealer is required to perform a reasonable level of due diligence on investment products and strategies before approving them for sale by their Dealing Representatives. The firm is required to develop an investor profile for investment products and strategies that have been approved by the firm. You should be fully versed in your firm's investor profiles for the investment products and strategies that you offer to your clients.

Investor Profile	• investors who the product would be suitable for
	• investors who the product would <u>not</u> be suitable for
	• investor profiles including:
	  - personal circumstances
	  - financial circumstances
	  - investment needs and objectives
	  - risk profile
	  - time horizon
	  - investment knowledge
	• concentration limits
	• other restrictions/controls

As a Dealing Representative, you are required to take reasonable steps to understand the essential facts about the investment products and strategies you offer to your clients as detailed below.

You must take reasonable steps to understand the investment product/strategy's:	• structure • features • risks • initial and ongoing costs • the impact of those costs

Your KYP Obligations

Under the KYP obligation, you are required to learn the essential facts about each investment product and investment strategy in order to fulfill your suitability obligation. In doing so, you are required to take reasonable steps to understand the investments' structure, features, risks, initial and ongoing costs, and the impact of those costs.

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Under Companion Policy (CP) 31-103, s. 13.2.1, you are also expected to:

- apply a more detailed consideration of investment products and strategies that are more complex or risky
- have a general understanding of the types of securities that are available through your firm in order to fulfill your obligation to consider a reasonable range of alternatives when making a suitability determination
- take reasonable steps to understand investments when acquired by transfer-in or by client-directed trade

Under your KYP obligations, you are required to:

- have a thorough understanding of the investment product and/or investment strategy
- clearly explain the investment product/strategy to clients

It is important for you to understand any product you recommend, but it is equally important to ensure that your client understands the product. Although your client may profess to know the product, you may need to ask some probing questions to verify that your client understands the information you have provided.

It is also very important that you document all details of your discussions with your clients. The documentary trail that you retain should include the product features, the range of alternatives available through your firm, how the investment product/strategy fits into their planned goals, and the downside risks.

Unapproved Investment Products and Strategies

Under the KYP obligation, you are prohibited from offering investment products or investment strategies that have not first been approved by your dealer.

Step 3: Suitability

The suitability obligation requires you to *know* the client, *know* the product, and to form an opinion as to whether the investment product is suitable for the client. You are obligated to ensure that any orders you accept and any recommendations you make are suitable based on the essential facts relative to your clients. However, the suitability obligation extends beyond orders and recommendations. You are required to make a suitability determination every time that you:

- open a new client account;
- accept an order
- make a recommendation

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- purchase, sell, deposit, exchange, or transfer investments for a client's account
- make a recommendation or decision to continue holding an investment
- take any other investment action for a client
- accept a client account (e.g. from another Dealing Representative)
- become aware of a material change in a client's circumstances
- become aware of a change in an investment within the client's account
- conduct a review of the client's KYC information
- exercise discretion, where permitted, to take any of the actions above

Under NI 31-103 and CP 31-103, you are required to satisfy a number of standards when making a suitability determination:

1. assess suitable options;
2. apply the "Client's Interest First" standard; and
3. document the basis for each suitability determination.

Assessing Suitable Options

Suitability determination starts with the identification and assessment of suitable options for a client. This involves the objective analysis of the Know Your Client (KYC) information for the client and the Know Your Product (KYP) information for the investment product or strategy. The impact of the proposed action on the client's account must then be weighed to consider whether the account will be suitable for the client, after the action has been completed.

Suitability assessment commonly starts with a comparison of the risk of the investment product/strategy compared to the risk profile of the client. This risk-based approach is an effective starting point and there are also correlations that can be made by comparing the KYC and KYP information related to investment objectives, time horizon, age, and investment knowledge. While these elements are key in determining suitability, all aspects of the client's KYC, the investment's KYP, and the client's existing holdings need to be considered.

After considering what the impact will be when the proposed action has been completed, the KYC and KYP information should be compared and used to consider whether:

- the KYC and KYP are aligned and the investment product/strategy is deemed suitable after the consideration of reasonable alternatives available through the registered firm
- the concentration of any investments within the account(s) are over-weighted

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- the investments in the account provide sufficient liquidity to meet the client's liquidity needs

"Client's Interest First" Standard

Following the assessment of suitable options for the client, you are then required to apply the "Client's Interest First" (CIF) standard. Therefore, in addition to the consideration of KYC and KYP factors, you must assess whether the proposed action is one that puts that client's interest first.

Under the CIF standard, you are required to put the client's interest first, ahead of your own interests and any other competing considerations, such as a higher level of remuneration or other incentives. You are required to consider, amongst other factors, the potential (or actual) impact of costs on the client's return on investment. Costs include all direct and indirect costs, such as:

- fees
- commissions
- charges
- trailing commissions
- any other costs associated with a proposed action

You are expected to assess both the:

- relative costs of the options available to clients
- impact of those costs on the client's overall return from any compensation paid, directly or indirectly, to you

Some investment products or strategies that are assessed to be suitable for a client, based on KYC and KYP, may not meet the "Client's Interest First" standard. Where you are not able to offer a client an investment option that is suitable and puts the client's interests first because the option is not available through your dealer, the regulators expect you to decline the client's account.

Documenting the Basis for Suitability Determination

Once you have made a suitability determination, you are required to document the reasonable basis for your suitability determination and how you have met your obligation to put the client's interest first including the:

- relevant facts
- key assumptions
- scope of data considered
- analysis performed

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You should maintain all client documents and recorded notes in the client's file and any electronic documents should be backed up and stored safely. Any changes to a previously agreed upon strategy should also be signed off by the client.

Trades Proposed by the Client

Trades and instructions which are proposed by the client, as opposed to being recommended by the Dealing Representative, are known as client-directed trades or unsolicited transactions. All such transactions are subject to the suitability obligation and you are required to make a suitability determination. If you receive instructions from a client which, in your view, will result in an unsuitable outcome, you are required to:

- inform the client that the transaction is not suitable and provide the basis of your suitability determination
- recommend alternative action which is suitable
- obtain recorded confirmation of the client's instruction where they proceed with the action despite the suitability determination

You and your dealer are under no obligation to accept a trade from a client that is determined to be unsuitable.

Behavioural Finance

The field of behavioural finance is one that tries to explain why clients make the decisions they make. Psychological biases, cognitive errors, and emotions can all play a part in how investors go about making decisions. As a Dealing Representative, it is important to know that investors' behaviour is not always predictable. An awareness of the main concepts of behavioural finance will help you be more aware of the errors in decision-making that we can all be susceptible to.

Traditional finance held that people are rational decision makers. Psychological biases arise because people rely on a combination of facts, probabilities, moods, and feelings in order to make a decision. In this sense, we are not computer-like. Cognitive errors occur due to our tendency to think through investment problems in a certain way.

Investor Behaviour

Investors can have a tendency to become overconfident. In other words, they tend to overestimate their knowledge and underestimate the risk of a given situation. You should know that overconfidence can lead to excessive trading or risk taking. Investors may also tend to sell winners too early and ride losers too long. This is known as the disposition effect. It comes about because people tend to perform actions that increase joy, i.e. selling a stock or fund that is up; and they tend to avoid actions that increase pain, i.e. selling a stock or fund that has gone down.

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Best Practices for Investment Planning

The first and most important step in the planning process is to establish a rapport with your client. It is important that you are able to convey a sense of trust. Effective client communication, through the use of written service agreements, can help establish trust. A written service agreement, also known as a client-planner engagement document, clearly outlines what you will be doing for the client, over what period of time, and at what cost. In addition, the agreement will outline the documents that you will require from the client and how you will safeguard the client's financial information. Be sure to follow your firm's policies and procedures governing service agreements and planning engagement documents.

In the initial meeting with your client, it may be beneficial to outline your approach to investment planning and the concepts or ideas that form the foundation of your approach to the planning process. Most importantly, you should clarify your responsibilities to your client, which should include an explanation of how you are compensated and any conflicts of interest.

You should place client education at the forefront of your relationship with your clients. The investment industry operates in a highly complex environment which can make it difficult for anyone, let alone a Dealing Representative, to understand which course of action will allow the client to meet their financial objectives. Client education empowers the client to understand and make decisions for themselves, with the help of their Dealing Representative to aid in the implementation of the plan.

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Lesson 2: Selecting Investment Funds

Introduction

Once you have collected and considered the essential facts about your client through the KYC process, the next step is to identify and recommend investment products and strategies that best meet your clients' needs and objectives. In this lesson you will learn about the information available on investment funds that will help you, as a Dealing Representative, assess and select suitable options.

This lesson takes approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- identify where to find information
- explain what type of investment fund information to research
- explain how to compare and select investment funds

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Investment Fund Information

Today's investment fund industry is a vast universe of sophisticated products spanning an immense range of investing opportunities. With so many investment options, it can be easy to become overwhelmed when it comes to trying to figure out which investment options are appropriate for each client.

Your dealer will have an approved list of investment funds and/or investment fund companies which you can select from. Through their relationships with investment fund providers, your firm may be able to provide sufficient information about the funds they have approved. However, there are a number of other information sources that you can access.

Investment Fund Research

Your clients will expect you to have information available to help them make decisions for their financial future. The Fund Facts makes it easier for investors to find and use key information about an investment fund. You are responsible for understanding the basic components of a Fund Facts and what each of these components cover. The table below highlights the major sections of the Fund Facts and the information provided within each section.

Section	Information Provided
Fund Name	the name of the investment fund
Quick facts	fund code, series start date, value of fund, MER, investment fund manager (IFM), portfolio manager (PM), distributions, minimum investment required
What does the fund invest in?	top 10 holdings, a pie chart of the investment mix (depending on the fund, by asset class, business sector, or geographic region)
How risky is it?	an explanation of volatility, the fund's risk rating (from low to high), reference to the risk section of the prospectus, a statement that the fund is not guaranteed
How has the fund performed?	a bar chart of the year-by-year returns for the past 10 years (or years available if less than 10), best and worst 3-month returns, average return (annual compounded return over the past 10 years)
Who is this fund for?	the objectives of an investor who should invest in the fund, the objectives of an investor who should not invest in the fund
A word about tax	general statement advising of potential taxes payable in registered and non-registered plans

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Section	Information Provided
How much does it cost?	Sales charge option (front-end or DSC[14]), fund expenses (management expense ratio (MER), trading expense ratio (TER)), other fees (short-term trading fee, switch fee, change fee), and trailer fees
What if I change my mind?	Investor rights including right to withdraw from the agreement to purchase, right to cancel purchase, right to claim damages
For more information	contact information for the investment fund manager (IFM), who to contact for the fund's prospectus and other disclosure documents, link to CSA "*Understanding Mutual Funds*" brochure

Comparing Investment Funds

There are many ways to quantitatively analyze an investment fund. One possible way is to use key indicators, such as 5-year annualized return, 5 years of annual returns, quartile rankings, volatility, MER, portfolio manager start date, and the Sharpe ratio.

The 5-year annualized rate of return is a measure of the return of the investment fund over the past 5 years. However, this number does not provide any insight into the consistency of returns. In order to measure consistency, the annual rate of return should be considered as well. Quartile rankings and volatility provide some insight into how the fund has performed relative to other Canadian equity funds with respect to return and risk, respectively. The lower the quartile (e.g. 1 or 2), the better the comparative performance. Funds in the 1st or 2nd quartile have outperformed the average fund in the peer group. Whereas, funds in the 3rd or 4th quartile have underperformed the average fund in the peer group.

The management expense ratio represents the overall cost of the fund on an annual basis. The portfolio manager's start date allows you to determine how much of the past return may have been a function of a manager who has lots of experience in managing that fund. Finally, the Sharpe ratio is a measure of the rate of return of the fund per unit of risk. The higher the Sharpe ratio, the better the return on a risk-adjusted basis.

The example below provides an investment fund comparison between two sample Canadian equity funds.

[14] Effective June 1, 2022, DSC Funds are banned in all jurisdictions. However, DSC Funds distributed prior to the ban may be held by investors and associated redemption schedules may apply.

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Key Indicators	Rhizome Canadian Equity Fund					Strata Canadian Equity Fund				
5-year Annualized Return	2.01%					3.62%				
Annual Returns	**2012**	**2011**	**2010**	**2009**	**2008**	**2012**	**2011**	**2010**	**2009**	**2008**
	8.93	-12.14	7.95	19.47	-29.45	4.59	-9.11	11.62	21.53	-27.34
Quartile Rankings	2	3	4	4	1	3	2	4	4	1
Volatility	Low					Low				
MER	2.50%					2.46%				
Portfolio Manager Start Date	October, 2007					May, 2013				
3-year Sharpe Ratio	0.13					0.41				

The two funds in the table above are fairly similar. This should be expected since they are both Canadian equity funds and they have similar MERs. The annualized return and the Sharpe ratio of the Strata fund is slightly higher.

Selecting Investment Funds

The decision on which investment fund to suggest for a client's portfolio is not straight forward. There are often a number of investment fund options and combinations that will meet a client's investment needs and objectives. As a result, many dealers provide their Dealing Representatives with access to software that will help in the decision-making process. The primary objective of software tools is to help you bring together a client's personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, and time horizon.

Using a software selection tool, you can select a number of investment funds that will meet the client's investment needs and objectives. You can then perform a quantitative analysis to determine which funds are most suitable for the client given what you know about the client from the KYC form.

In our previous example under the section titled "Comparing Investment Funds", it appears that the Strata fund may be a slightly better choice for the Canadian equity portion of a client's portfolio since it offers a slightly better return at the same level of risk. One issue may be the portfolio manager's start date, which may suggest that you should further assess the fund to ensure that it is well aligned with the suitability requirements of the client.

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All aspects of the client's KYC, the investment's KYP, and the client's existing holdings need to be considered. You cannot assess suitability only on a trade by trade basis. You must encompass a portfolio approach in order to consider the impact of factors such as risk, concentration of investments, and liquidity in the client's portfolio.

When your assessment of the investment funds is complete, you are then required to apply the "Client's Interest First" standard. Therefore, in addition to KYC and KYP factors you have evaluated, you must assess whether the proposed action is one that puts that client's interest first.

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Lesson 3: Asset Allocation

Introduction

As a Dealing Representative, it is important that you understand the factors to consider when determining how to allocate clients' assets to best achieve their investment needs and objectives. In this lesson, you will learn about asset allocation and the factors to consider when allocating assets, the life cycle hypothesis, as well as how to re-balance a client's portfolio.

This lesson takes approximately 15 minutes to complete.

At the end of this lesson, you will be able to:

- discuss asset allocation
- differentiate between target and tactical asset allocation
- explain the life cycle hypothesis
- discuss re-balancing the portfolio

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Allocating Assets

To achieve protection of capital, growth, and diversification, you may want to advise clients to hold a variety of investments, including investment funds. The process of mixing investment assets among different types of investment products, such as cash, fixed income, equity, real estate, derivatives, private investments, and collectibles, is commonly known as asset allocation.

No one type of investment fund is the best performer over all time periods. In some years, equity funds are the top performers, while in others, fixed income funds have been the leaders. From time to time, money market funds have produced higher returns than either fixed income or equity funds. By choosing the optimal mix of investments at any given time, an investor should theoretically be able to generate higher and more stable risk-adjusted returns rather than by investing in one type of asset.

When investing in investment funds, there are three ways of implementing an effective asset allocation strategy.

1. You can decide upon an asset allocation strategy and periodically rebalance the asset allocation when needs arise. This is known as target asset allocation.

2. You can periodically shift the proportion (also known as the weighting) of different types of funds within a client's account according to your assessment of investment opportunities. This is known as tactical asset allocation.

3. You can take advantage of asset allocation services offered by some investment fund organizations. These services advise investors on appropriate changes in asset mixes among different funds, often based on a computer model. One such automated approach is life cycle investing, where the amount of riskier assets held decreases as the investor moves closer to retirement.

Asset Mix

The following table gives examples of some common asset allocations.

Name	Description	Sample Asset Mix
Aggressive Growth	This portfolio has a 100% weighting in equities with a goal of maximizing return at an acceptable level of risk.	100% equities
Growth	This portfolio has a heavy weighting in equities with a smaller percentage allocated to fixed income.	70-90% equities; 10-30% fixed income

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Name	Description	Sample Asset Mix
Balanced	This portfolio holds equities, fixed income, and cash to provide a combination of long-term capital growth and income.	50-60% equities; 35-40% fixed income; 5-10% cash
Conservative	This portfolio has a higher weighting in fixed income with a smaller component in equities.	10-30% equities; 60-70% fixed income; 10-20% cash
Ultra-Conservative	This portfolio is suitable for investors who wish to establish an emergency fund or who want minimal exposure to risk.	100% cash

Example: Aggressive Growth

Bob is a single, 27-year-old lawyer working for a major downtown law firm. His annual income before taxes is currently $90,000, with the possibility of six figures in the next few years. So far, Bob has saved $30,000 towards his goal of retiring at age 65. Bob has a good understanding of financial markets and has even invested in individual stocks over the past two years. He considers himself a risk taker and his income potential affords him the luxury of taking such risks. Given Bob's high risk profile and income potential, an aggressive growth portfolio seems appropriate for him. Bob is a knowledgeable and experienced investor with a long time horizon. His main objective is to pursue long-term growth opportunities.

Example: Balanced

Joe Campbell is a 45-year-old account representative and his wife, Jane, is a 43-year-old nurse. They have 2 children aged 8 and 10. Their goal is to retire at age 60, but they can wait until age 65 if necessary. Combined, they have an after-tax income of $78,000. Since $54,000 goes to expenses, they have $24,000 per year to invest. Both Joe and Jane have company pensions and their RRSP assets are worth $65,000. They are inexperienced investors but are willing to accept some risk as long as the investments are of good quality. Essentially, they are comfortable with a moderate amount of risk. With their medium risk profile, the Campbells should probably consider a balanced portfolio.

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Example: Conservative

Rick and Marilyn Brady are both 64 years old and looking forward to retiring next year. Rick owns a hardware store in the small town where the Bradys reside, while Marilyn works as the town's primary care physician. The Bradys live comfortably, but do not have an extravagant lifestyle. Over the years, they have been able to accumulate $700,000 in their RRSPs and another $475,000 in non-registered funds.

They started investing in investment funds 20 years ago, but their financial advisor retired last year and they are looking for someone new to help them. Although they have a solid understanding of investment funds, the Bradys feel that once they enter retirement, they do not want to worry about their finances. Since the couple want to preserve their capital and begin drawing an income next year, a conservative portfolio would seem appropriate for their needs.

Target and Tactical Asset Allocation

Portfolio managers that use target asset allocation set a target asset mix to achieve a certain level of growth over a long investment time horizon. From time to time, the values of the securities in the investment fund may change and cause the fund's assets to deviate from its target asset allocation. When this happens, the portfolio manager will rebalance the mix back to its target asset allocation.

Portfolio managers that use tactical asset allocation have flexibility to change the asset allocation in the fund to take advantage of opportunities in the market.

Example

Linda sets the asset allocation for the Anova International Equity Fund in Year 1 as follows:

Asset Allocation Year 1	
Canadian Equity	25%
U.S. Equity	20%
International Equity	15%
Canadian Bonds	40%

In year 2, Linda analyzes economic indicators and changes the portfolio's asset mix to take advantage of opportunities in the market.

Asset Allocation Year 2	
Canadian Equity	25%
U.S. Equity	35%
International Equity	20%
Canadian Bonds	20%

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Whether these tactical allocations are permitted on a short-term or longer-term basis will be outlined in the fund's prospectus. There may be higher risk with tactical asset allocation funds since weightings in equities can be higher for longer.

Life Cycle Investing

Life cycle investing assumes that as investors move through life, the investment strategy should change. A traditional approach is to use the investor's age as the basis for changing the asset allocation of a lifecycle investment fund. As the investor gets older, the asset allocation changes from riskier assets to less risky assets. This would be like starting out with an aggressive growth investment fund in the client's 20s and moving towards a conservative portfolio as the client approaches retirement. In other words, lifecycle investment funds move the investor away from equities towards fixed income and cash. Usually, lifecycle investment funds will automatically move the investor away from riskier assets towards less risky assets. Lifecycle investment funds are also known as target date funds or lifestages funds.

Although there is some merit to lifecycle funds, you should always keep in mind that the client's personal circumstances, financial circumstances, investment needs and objectives, investment knowledge, risk profile, and time horizon should be the basis for deciding which asset allocation strategy is appropriate.

It is important to be aware that a client's KYC profile will change over time including their investment needs and objectives, risk profile, time horizon, liquidity needs, financial circumstances, and so on. Some of these criteria can be anticipated to change over time. For example, an investor's knowledge, experience, and age will increase over time. On the other hand, the investor's time horizon will decrease. Other factors are less predictable such as a client's investment needs and objectives, risk profile, and financial circumstances. You can best serve your clients by helping them to clarify their investment needs and objectives, understand their risk profile, and regularly assess their financial circumstances by regularly updating their Know Your Client (KYC) information.

KYC must be reviewed with clients and, where necessary, updated no less than:

- when there is a material change in the client's circumstances and/or KYC criteria
- every 36 months

Portfolio Re-Balancing

As a client's personal and financial circumstances change over time, their portfolio will need to be re-balanced. Before making any changes to a client's portfolio, it is important to consider the taxes and fees associated with any plan. Taxes are only a concern for non-registered portfolios since registered savings plans either defer, or completely eliminate, the taxation of capital gains from the disposition of investments. However, re-balancing a client's non-registered portfolio will have tax implications.

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Since re-balancing both registered and non-registered portfolios can likely involve the disposition of investment funds and investment into new funds. you will need to give serious consideration to any fees and costs involved in the re-balancing of the portfolio.

A portfolio manager who manages an investment fund that follows a target asset allocation will most likely rebalance the portfolio each year on a pre-determined date. A portfolio manager that uses a tactical asset allocation strategy will regularly review the fund's portfolio and make changes as market forces dictate. A portfolio manager who uses a lifecycle asset allocation strategy will change the fund's asset mix away from equities and towards fixed income as the target date approaches.

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Lesson 4: Tax Efficient Strategies

Introduction

As a Dealing Representative, you must understand your client's tax situation and how your recommendations can impact their personal income tax. In this lesson, you will learn about different tax efficient strategies and tax efficient investment funds. You will also learn how to structure a client’s portfolio to maximize tax efficiency.

This lesson takes approximately 10 minutes to complete.

At the end of this lesson, you will be able to:

- discuss various tax efficient strategies
- discuss tax efficient investment funds
- discuss structuring a client’s portfolio for tax efficiency between registered and non-registered plans

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Tax Efficiency

Tax is an integral part of any investment strategy. As a Dealing Representative, you must understand your client's tax situation and how your recommendations can impact their personal income tax. Since there is different tax treatment for the various types of income, it is possible to arrange a portfolio to be more tax efficient. Tax efficiency refers to investment strategies that minimize taxes when investing.

In general, income that does not have preferential tax treatment, such as interest income, should be held in registered plans as much as possible. Income with preferential tax treatment, such as dividends and capital gains, should be held in non-registered plans as much as possible. In some instances, the structure and/or investment objective of the investment fund itself will result in a tax efficient investment.

Tax Efficient Investment Funds

The following types of investment funds tend to be the most tax efficient:

- funds that invest heavily in equities
- funds that use index investing
- funds that use a buy-and-hold strategy

NOTE: You should be aware of any tax implications that may arise from your recommendations. Ensure that your client seeks tax advice from a qualified professional.

Taxation of Registered Plans and Non-Registered Accounts

Registered plans are savings plans that are defined in the federal Income Tax Act, registered with the Canada Revenue Agency (CRA), and administered by various financial institutions. These types of plans are granted special tax status where contributions may be tax deductible and taxes payable on any investment earnings may be deferred or eliminated. There are also a number of limitations/restrictions on these plans including how withdrawals are treated for tax purposes.

The table below highlights the tax implications of contributions, investment earnings, and withdrawals for the five main types of registered accounts.

Account Type	Are Contributions Tax Deductible?	Are Investment Earnings Taxable Every Year?	Are Withdrawals Tax-Free?
Tax-free Savings Account (TFSA)	No	No	Yes

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Account Type	Are Contributions Tax Deductible?	Are Investment Earnings Taxable Every Year?	Are Withdrawals Tax-Free?
Registered Education Savings Plan (RESP)	No	No	EAP & investment income withdrawals are taxable; Withdrawals of subscriber contributions are tax-free
Registered Retirement Savings Plan (RRSP)	Yes	No	No
Registered Retirement Income Fund (RRIF)	N/A	No	No
Registered Disability Savings Plan (RDSP)	No	No	DAP & investment income withdrawals are taxable; Withdrawals of contributor contributions are tax-free
First Home Savings Account (FHSA)	Yes	No	Yes for “qualified” withdrawals used to purchase or build a home

NOTE: EAP refers to educational assistance payments and DAP refers to disability assistance payments. When considering flexibility alongside tax efficiency, RRSPs are very effective savings vehicles since any deposits result in a tax deduction. The value of an RRSP is enhanced if the tax refund is reinvested into the RRSP. TFSAs are tax efficient because withdrawals are tax-free and can be re-deposited the following calendar year with no negative impact on the plan-holder’s contribution room. FHSAs are tax efficient because they offer the benefits of RRSPs, tax deductible contributions, and the benefits of TFSAs, tax-free withdrawals.

Types of Income

Investment funds earn and distribute various types of income. It is important to be able to differentiate the income that can be generated by investment funds to understand the tax implications of the income.

- interest income
- Canadian dividend income
- other income, such as income from foreign property

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- capital gains or losses

Interest income does not have preferential tax treatment, whereas dividends and capital gains do have preferential tax treatment. Therefore, investments that generate interest income are often best allocated to registered plans, where tax is deferred, rather than to non-registered accounts. Investments that generate dividends and capital gains are often best allocated to non-registered accounts since the preferential tax treatment is not available in registered plans.

Example

Maria holds a bond fund and an equity index fund in a non-registered account. She wants to contribute one of these funds to her RRSP, where it will be sheltered from tax. From a tax efficiency point of view, which one should she contribute?

Maria's bond fund generates mostly interest income, which if held in her non-registered account, would be fully taxable. Alternatively, her index fund generates dividends and capital gains, which receive preferential tax treatment. The index fund also has minimal trading in the portfolio, which means that capital gains are minimized.

Therefore, Maria should contribute the bond fund to her RRSP.

Note: When making any contributions to an RRSP in kind, there may be a tax consequence arising from the disposition and contribution.

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Summary

Congratulations, you have reached the end of Unit 11: Making Recommendations.

In this unit you covered:

- Lesson 1: Evaluating the Client
- Lesson 2: Selecting Investment Funds
- Lesson 3: Asset Allocation
- Lesson 4: Tax Efficient Strategies

Now that you have completed these lessons, you are ready to assess your knowledge with a 10-question quiz. To start the quiz, return to the IFSE Landing Page and click on the Unit 11 **Quiz** button.

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